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Politics this week

Feb 19th 2009
From The Economist print edition

AFP

Venezuela's president, Hugo Chávez, won his referendum to abolish term limits by 55% to 45%. He said it was a victory "for socialism, for revolution" and that he would be a candidate in the next presidential election in 2012. The opposition complained that his "yes" campaign used public money and state facilities. See article

A month-long general strike in **Guadeloupe**, a French territory in the Caribbean, turned violent. A protester was killed and businesses were looted. France dispatched 260 gendarmes. The strikers want an increase in the minimum wage; many also resent the fact that a lot of businesses are white-owned in a mainly Afro-Caribbean island. See article

Several hundred people blocked bridges at three cities on **Mexico's** border with the United States to protest against the use of Mexican troops to fight drug-traffickers. They claim that troops have committed abuses. Traffickers killed four policemen in Ciudad Juárez, one of the cities.

A cruise ship carrying 64 tourists to **Antarctica** ran aground in high winds. The ship's operator dispatched a rescue vessel. The navies of Chile and Argentina have expressed worries that the growth in tourist traffic in the area will cause a serious accident.

Oops

It emerged that two **submarines** carrying missiles armed with nuclear weapons—one British and one French— accidentally collided beneath the Atlantic earlier this month. The two countries said there were no injuries when *Le Triomphant* and *HMS Vanguard* bumped into each other "at low speed", apparently unaware of each other's presence, during routine patrols. The weapons remained safe, they said.

An Italian court sentenced a British lawyer, **David Mills**, the separated husband of a British minister, Tessa Jowell, to four-and-a-half years in prison for taking a $600,000 bribe from Italy's prime minister, Silvio Berlusconi. Mr Berlusconi does not face prosecution, thanks to a law granting him immunity while in office.

Markets were spooked by more bad economic news in much of eastern and central Europe. Fears rose that **Ukraine** might refuse to abide by the terms of an IMF bail-out and default on its debt. In **Poland** the zloty fell further, hurting many who took out home loans in foreign currencies. In **Russia**, the rouble slid as the Kremlin forecast that the economy would contract by 2.2% this year. See article

Inflation buster

Morgan Tsvangirai, **Zimbabwe's** prime minister under a power-sharing agreement with President Robert Mugabe, said he would pay civil servants in foreign currency. Western governments sounded sceptical as to whether he could afford to do so. See article

Equatorial Guinea's island capital was unsuccessfully attacked by men in gunboats while President Obiang Nguema was away on the mainland part of his country. He survived a coup attempt five years ago by mercenaries from South Africa.

King Abdullah of **Saudi Arabia** made the most thorough reshuffle of his government since assuming the throne in 2005. He promoted reformers, sacked reactionaries and appointed his first-ever female minister, for women's education. But women are still not allowed to drive a car.

Egypt's authorities freed Ayman Nour, who had the temerity to run against Hosni Mubarak for the presidency in 2005, after he had served three years of a five-year sentence for fraud. Mr Nour says the charge was trumped up.

Shifting priorities

Hillary Clinton embarked on her first tour abroad as America's secretary of state, visiting Japan, Indonesia, China and South Korea. The choice of Asian destinations was seen as symbolising the Obama administration's determination to give the region new prominence in **American diplomacy**. Mrs Clinton invited Taro Aso, Japan's prime minister, to become the first foreign leader to meet Barack Obama in Washington since his inauguration. See article

Mr Obama said America would send a further 17,000 troops to join the 65,000 foreign soldiers already based in **Afghanistan** to combat the worsening insurgency. America wants its NATO allies to dispatch reinforcements, too. See article

EPA

Taro Aso, Japan's prime minister, visited the Russian island of **Sakhalin** for the opening of a liquefied natural-gas plant. He met Dmitry Medvedev, the Russian president, for talks on resolving the two countries' long-running dispute over four islands held by Russia and claimed by Japan.

Pakistan's government agreed a truce to end fighting with Islamist insurgents in the Swat valley in its North-West Frontier Province. As part of the agreement, *sharia* law will be implemented in the district. NATO commanders in neighbouring Afghanistan expressed concern at the deal. See article

Thirty years after the downfall of **Cambodia's Khmers Rouges**, the first trial of one of their leading members for crimes committed during their rule began in Phnom Penh. The defendant is Kaing Guek Eav, known as Duch, who ran the notorious Tuol Sleng interrogation centre. See article

Spend, spend, spend

AP

Barack Obama signed his $787 billion **stimulus package** into law at a ceremony in Denver. It is hoped that the bill will create or save 3.5m jobs. Mr Obama then travelled to Phoenix where he unveiled a $75 billion bail-out plan for **homeowners** facing foreclosure. See article

Judd Gregg withdrew his nomination for commerce secretary on February 12th. The New Hampshire senator, a Republican, cited differences with the White House over both the stimulus bill and its desire to control next year's census of the population. See article

Frantic negotiations to pass **California's** budget took place as the process to lay off thousands of state workers began. Some Republicans in the legislature remained unhappy at a temporary tax increase in the bill, and ousted their leader in the state Senate after he agreed to support the measure so that the budget could pass. See article

The founder of an Islamic television station in upstate New York that was set up to improve the image of Muslims was charged with **beheading** his wife. The couple had filed for divorce. The local prosecutor described it as "the worst form of domestic violence", sparking outrage from feminists, who say the murder resembles an "honour killing".

Business this week

Feb 19th 2009
From The Economist print edition

General Motors and **Chrysler** submitted survival plans to the government, a condition of the $17.4 billion in bail-out funds they received last year. GM intends to close another five factories in addition to the nine it has already announced, reduce its global workforce by 47,000, dispense with thousands of dealerships, phase out its Hummer and Saturn brands if it cannot find a buyer and reduce production of its Pontiac range. It is also trying to sell Saab, its Swedish unit. Chrysler said it would cut capacity by another 100,000 vehicles a year. Both carmakers asked for more government aid: GM wants an extra $16.6 billion and Chrysler a further $5 billion. See article

Daimler reported a net loss of €1.5 billion ($2.1 billion) for the fourth quarter, as it took charges relating to its remaining stake in Chrysler. The German carmaker's annual profit fell by 65%, hurt in part by a drop in demand for its Mercedes marque.

It's just not cricket

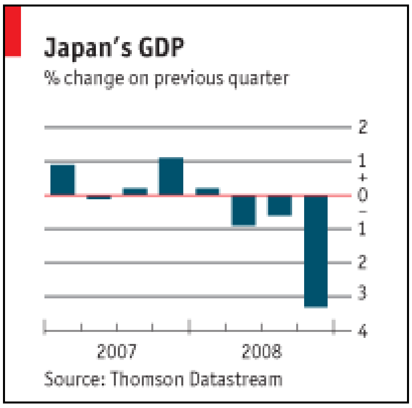
The Securities and Exchange Commission charged **Sir Allen Stanford**, a Texan billionaire, with an $8 billion fraud. The allegations centre on Stanford International Bank, which operates from Antigua; many investors who have lost money are from Latin America. The charges are an embarrassment for England's cricket board, which had been negotiating a sponsorship deal with Sir Allen. Last year, he put up $20m for a controversial tournament in which England played Sir Allen's team of Caribbean all-stars. See article

UBS agreed to provide American authorities with the names of some 250 clients who used the Swiss bank to shield their money from America's tax regime. This forms part of a settlement in a criminal investigation alleging that UBS enticed the super-wealthy to open accounts protected by Switzerland's secrecy rules; it is the first time that Swiss regulators have allowed a bank to disclose the identity of account-holders. UBS will also pay $780m to end the criminal case.

Moody's downgraded its AAA credit rating for **Lloyds Banking Group**. It was a further blow for the bank. Earlier Lloyds had said that HBOS, which it acquired in a government-backed acquisition, would make an annual loss of £10 billion ($14.4 billion). As its share price dived, speculation mounted that Lloyds, which is now 43% owned by the British taxpayer, may have to be fully nationalised. See article

Worse than expected

Japan's economy contracted by 3.3% in the last three months of 2008 compared with the previous quarter (or 12.7% at an annualised rate), as exports slumped and domestic consumption weakened. Japan isn't the only East Asian country to be buffeted by the global slowdown: **Taiwan's** GDP in the fourth quarter shrank by 8.4% compared with the same period a year earlier. See article



Shoichi Nakagawa resigned as Japan's finance minister amid a row over whether he was drunk at a recent G7 news conference. His replacement is Kaoru Yosano, the minister for economic policy, who says he recognises that the country is facing the "biggest economic crisis since the war".

The Federal Reserve unveiled new "longer term" projections for **inflation** that will be consistent with its mandate to promote maximum employment and price stability. It is the first step towards the inflation targeting that some economists have argued for.

China Minmetals, which operates under the purview of the state, rode to the rescue of **OZ Minerals**, an Australian mining company saddled with debt, offering to pay A$2.6 billion ($1.7 billion) for the world's second-largest producer of zinc. As with the Rio Tinto/Chinalco deal, Australian regulators will examine

rules on foreign ownership.

China and **Russia** signed a big energy deal. China agreed to lend $25 billion to Rosneft, Russia's state-owned oil company, and Transneft, its pipeline monopoly, in return for the supply of 300,000 barrels of oil a day (or about 10% of China's current oil imports) over the next 20 years.

Getting Sirius

Sirius XM, America's only subscription-based radio broadcaster, avoided having to file for bankruptcy protection when **Liberty Media**, a conglomerate, agreed to loan it $530m in exchange for equity and seats on the board, one of which is expected to go to John Malone, Liberty's boss. See article

Trump Entertainment Resorts sought bankruptcy protection for the second time in four years. Founded by Donald Trump, the company, which accounts for about 1% of the property mogul's net worth, operates hotel-casinos in Atlantic City. Along with Las Vegas it is suffering from depressed gambling revenues. Mr Trump and his daughter, Ivanka, recently quit the board after disagreeing with management and bondholders.

KAL's cartoon

Feb 19th 2009
From The Economist print edition

Illustration by KAL

The economy

The collapse of manufacturing

Feb 19th 2009
From The Economist print edition

The financial crisis has created an industrial crisis. What should governments do about it?

Alamy

$0.00, not counting fuel and handling: that is the cheapest quote right now if you want to ship a container from southern China to Europe. Back in the summer of 2007 the shipper would have charged $1,400. Half-empty freighters are just one sign of a worldwide collapse in manufacturing. In Germany December's machine-tool orders were 40% lower than a year earlier. Half of China's 9,000 or so toy exporters have gone bust. Taiwan's shipments of notebook computers fell by a third in the month of January. The number of cars being assembled in America was 60% below January 2008.

The destructive global power of the financial crisis became clear last year. The immensity of the manufacturing crisis is still sinking in, largely because it is seen in national terms—indeed, often nationalistic ones. In fact manufacturing is also caught up in a global whirlwind.

Industrial production fell in the latest three months by 3.6% and 4.4% respectively in America and Britain (equivalent to annual declines of 13.8% and 16.4%). Some locals blame that on Wall Street and the City. But the collapse is much worse in countries more dependent on manufacturing exports, which have come to rely on consumers in debtor countries. Germany's industrial production in the fourth quarter fell by 6.8%; Taiwan's by 21.7%; Japan's by 12%—which helps to explain why GDP is falling even faster there than it did in the early 1990s (see article). Industrial production is volatile, but the world has not seen a contraction like this since the first oil shock in the 1970s—and even that was not so widespread. Industry is collapsing in eastern Europe, as it is in Brazil, Malaysia and Turkey. Thousands of factories in southern China are now abandoned. Their workers went home to the countryside for the new year in January. Millions never came back (see article).

Factories floored

Having bailed out the financial system, governments are now being called on to save industry, too. Next to scheming bankers, factory workers look positively deserving. Manufacturing is still a big employer and it tends to be a very visible one, concentrated in places like Detroit, Stuttgart and Guangzhou. The failure of a famous manufacturer like General Motors (GM) would be a severe blow to people's faith in their own prospects when a lack of confidence is already dragging down the economy. So surely it is right to give industry special support?

Despite manufacturing's woes, the answer is no. There are no painless choices, but industrial aid suffers from two big drawbacks. One is that government programmes, which are slow to design and amend, are too cumbersome to deal with the varied, constantly changing difficulties of the world's manufacturing industries. Part of the problem has been a drying-up of trade finance. Nobody knows how long that will last. Another part has come as firms have run down their inventories (in China some of these were stockpiles amassed before the Beijing Olympics). The inventory effect should be temporary, but, again, nobody knows how big or lasting it will be.

The other drawback is that sectoral aid does not address the underlying cause of the crisis—a fall in demand, not just for manufactured goods, but for everything. Because there is too much capacity (far too much in the car industry), some businesses must close however much aid the government pumps in. How can governments know which firms to save or the "right" size of any industry? That is for consumers to decide. Giving money to the industries with the loudest voices and cleverest lobbyists would be unjust and wasteful. Shifting demand to the fortunate sector that has won aid from the unfortunate one that has not will only exacerbate the upheaval. One country's preference for a given industry risks provoking a protectionist backlash abroad and will slow the long-run growth rate at home by locking up resources in inefficient firms.

Nothing to lose but their supply chains

Some say that manufacturing is special, because the rest of the economy depends on it. In fact, the economy is more like a network in which everything is connected to everything else, and in which every producer is also a consumer. The important distinction is not between manufacturing and services, but between productive and unproductive jobs.

Some manufacturers accept that, but proceed immediately to another argument: that the current crisis is needlessly endangering productive, highly skilled manufacturing jobs. Nowadays each link in the supply chain depends on all the others. Carmakers cite GM's new Camaro, threatened after a firm that makes moulded-plastic parts went bankrupt. The car industry argues that the loss of GM itself would permanently wreck the North American supply chain (see article). Aid, they say, can save good firms to fight another day.

Although some supply chains have choke points, that is a weak general argument for sectoral aid. As a rule, suppliers with several customers, and customers with several suppliers, should be more resilient than if they were a dependent captive of a large group. The evidence from China is that today's lack of demand creates the spare capacity that allows customers to find a new supplier quickly if theirs goes out of business. When that is hard, because a parts supplier is highly specialised, say, good management is likely to be more effective than state aid. The best firms monitor their vital suppliers closely and buy parts from more than one source, even if it costs money. In the extreme, firms can support vulnerable suppliers by helping them raise cash or by investing in them.

If sectoral aid is wasteful, why then save the banking system? Not for the sake of the bankers, certainly; nor because state aid will create an efficient financial industry. Even flawed bank rescues and stimulus plans, like the one Barack Obama signed into law this week, are aimed at the roots of the economy's problems: saving the banks, no matter how undeserving they are, is supposed to keep finance flowing to all firms; fiscal stimulus is supposed to lift demand across the board. As manufacturing collapses, governments should not fiddle with sectoral plans. Their proper task is broader but no less urgent: to get on with spending and with freeing up finance.

Debris in space

Flying blind

Feb 19th 2009
From The Economist print edition

The tragedy of the commons meets the final frontier

AP

THE Earth's orbit is getting crowded. The past few years have witnessed huge growth in the number of satellites. Unfortunately, wherever civilisation ventures it leaves a trail of rubbish. Of the 18,000 tracked objects travelling around the Earth that are larger than 10cm (4 inches), only about 900 are active satellites. The rest is debris—everything from fragments of paint to entire dead satellites and bits of old rockets. Smashed bits of space equipment orbit along with items dropped by astronauts, including tools and the odd glove.

That is quite enough trash, without needlessly creating vastly more of the stuff by smashing up satellites. Yet the destruction of the Chinese *Fengyun-1*C in an anti-satellite missile test in 2007 accounts for more than a quarter of all catalogued objects in low-Earth orbit. And the collision of an American commercial satellite and a defunct Russian military one has just added thousands more pieces of debris. For the sake of the whole planet, the space industry needs to clean up its act.

In space no one can hear you clean

Space junk is dangerous. Anything larger than a fleck of paint poses a hazard to the useful working satellites that surround the Earth, and on which the world increasingly depends for communications, broadcasting and surveillance. Space waste is not biodegradable. You cannot sweep it up. Instead, it will stay in orbit for decades, or even centuries, before it eventually falls to earth and burns up.

As the pile of rubbish grows, so does the risk of collisions. In the 1970s one NASA scientist pointed out that debris from one collision could go on to create a second, which would create still more debris and more collisions, and so on. Eventually, an entire orbit would be rendered useless for generations.

The orbits around the Earth are too valuable to let this happen. Space is a public common and humanity needs to value it. So it is time to stop so many satellites from flying blind. Although some organisations collect and analyse data on potential collisions, they are not always precise and there are gaps in their knowledge—as the recent collision has shown. The European Space Agency has said it will encourage space agencies to share more information. It will also establish standards for working more closely with America.

But that is too modest. What is needed is an international civil satellite-awareness system that would

provide everyone from small governments to business with the information they need to operate safely. To create such a system cheaply, however, requires countries to pool information from their separate ground sensors. The system should lay down the rules of the road, such as who has to give way. All space-faring countries should comply with international guidelines to minimise the amount of debris created by launches. There is a strong case for a moratorium on debris-creating anti-satellite tests. And satellite-launchers should be obliged to buy insurance to cover the risk of extra costs before they venture into space, rather as car-drivers must before they take to the road. One such cost arises when a satellite has to take evasive action and thereby uses up fuel, reducing its life in orbit.

This plan need not be expensive, but it faces one big difficulty. Because orbit is open to anyone with a launch-rocket handy, some countries may be tempted to let everyone else bear the costs of precaution while they reap the benefits. The space powers can use all sorts of levers to bring such recalcitrants round, from access to technology to moral pressure. Ultimately, though, if free riders refuse, it is important that the resulting stink does not block an agreement altogether. Do not let the mess on the ground exacerbate the mess in the skies above.

Saudi reforms

No time to lose

Feb 19th 2009
From The Economist print edition

King Abdullah has made some welcome changes. He must hurry up and make a lot more

Reuters

THE kingdom of Saudi Arabia may be the world's last country to let a woman into its government—albeit giving her a post that deals only with educating females. The lady in question still cannot drive herself to work. Nor may she travel in a car without her husband or a closely related male chaperone to ensure that she upholds her moral standards.

But at least King Abdullah, an 86-year-old, is himself driving in the right direction, hitherto at a snail's pace. All the other changes that have resulted from his government shuffle—in the royally appointed proto-parliament known as the Shura Council, in the armed forces, in the courts, at the central bank, among the clergy, even in the frightful religious police—have been for the good (see article). Most daring of all, though unmentioned in his recent pronouncement, is the prospect that the gerontocratic method whereby Saudi kings have been succeeded, one after another, by a brother, each being a son of the state's gloriously procreative founding father, Abdel Aziz ibn Saud, may be dropped in favour of a prince from the younger generation. A callow stripling of 60 or so may then conceivably be allowed to steer the kingdom faster towards modernity and perhaps even greater justice, equality and choice; forget the infamy of full democracy for now.

The pity is that the reforms have come so late and have previously been so tentative. After all, the king has been running the show since his half-brother, King Fahd, suffered a stroke in 1995. When he came to the throne in 2005, Abdullah's friends predicted a spurt towards modernity and a less illiberal society. Senior princes insisted that permission for women to drive—never the topmost priority but a signal of intent—would soon be granted. Shortly before he became king, Abdullah endorsed an element of choice in local elections, but the councils that resulted have proved feeble, and backward-looking Islamists have emerged as the loudest voices within them. Reforming education and the courts has been impeded. Divisions and dithering in the upper ranks of the royal family have led to calls for caution. Even after the latest changes, the crown prince, Sultan, is still minister of defence, a mere 46 years after taking the post; Prince Saud, the foreign minister, stays in his job, 34 years on. A noted reactionary, Prince Nayef, another of the king's brothers (one of 44 recognised sons of Abdel Aziz), still runs the interior ministry, his fief since 1975.

The chief reason aired in defence of this near-paralysing slowness to reform is that the people of the kingdom are themselves loth to countenance rapid change and that the Wahhabist clergy, with whom the royal family made a compact nearly nine decades ago, would not tolerate moves towards a more liberal and secular society. The disciples of Osama bin Laden are still itching to accuse the king of ungodliness should he go down a venal Western path. The king, it is said, cannot breezily ignore the reactionaries; he

is doing his best.

This is true up to a point. Yet it is also true that frustration and resentment in Saudi Arabia are growing—and look set to go on doing so. Nearly half of university graduates are women, yet less than a tenth of them have proper jobs outside the home. As the oil price plummets, unemployment may rise dangerously. As the internet draws the young into the outside world, irritation at restrictions—against the cinema, against music, even against jingles in mobile telephones—will grow. On the day the king declared his changes, the religious police checked shops to ensure that none was selling Valentine's Day cards, those harbingers of paganism and Christianity. Though the king has opened an admirably ecumenical dialogue with leaders of other faiths, and even shown cautious signs of reaching out to Israel, no church or synagogue may yet be built on Saudi soil. There is almost no chance that this edition of *The Economist* will be allowed on sale at kiosks.

Hamlet with 8,000 princes

King Abdullah should be praised for his latest changes, late as they may be. But at the end of the day the question is for how long just one extended family, said now to comprise perhaps 8,000 princes, will be able to control the country's power and wealth, founded simply on the fact of its holding more than a fifth of the world's oil reserves. The old saw, that if you allow a little democracy you end up by getting the whole caboodle, applies to this kingdom too. It would be good if the new succession mechanism, run by a so-called Council of Allegiance, were able to skip the present ruling generation in search of a more youthful and dynamic monarch. But in the longer run the Saudi people, like most people, will want not just a bigger slice of the cake but also the chance to wield some real political power for themselves.

Fighting the Taliban

A strategy for avoiding defeat

Feb 19th 2009
From The Economist print edition

America needs to show more patience—and more delicacy—on both sides of the Afghan-Pakistani border

IT IS widely understood that the West's war with the Taliban in Afghanistan cannot be won inside that country's borders alone. So long as the "semi-autonomous" badlands of Pakistan's tribal areas provide refuge for terrorists, Afghanistan—and the West—will never know security. A lasting settlement must also meet the interests of other countries in the region, including Iran, India and Russia. So it is encouraging that Barack Obama's administration is embracing a "regional" approach, with the appointment of Richard Holbrooke, a punchy senior diplomat, as envoy to "AfPak". But other sources of encouragement have been scarce of late (see article). This week's decision to send a further 17,000 American troops to Afghanistan is in part a sign of how badly the war is going.

"Victory", defined in terms that get more modest by the month, seems more distant than ever. Worse, the prosecution of the war seems to be risking an even more calamitous strategic defeat: the Talibanisation of Pakistan, an Islamic country of 170m people that happens to possess a nuclear arsenal.

That, thankfully, is still a distant prospect. The danger of Pakistan failing as a state is often overstated. The government's writ still runs in the parts where most of its people live—and the vast majority of those people have moderate views. When given the chance to vote, they unambiguously reject Islamist parties. And the election last year restored Pakistan's fragile democracy. Though notorious for corruption, Pakistan's civilian politicians have usually done better than the military men in resisting Islamist extremism. President Asif Zardari and Yusuf Raza Gilani, the prime minister, deserve patience. The alternative, military rule, is what got Pakistan into this mess.

The problem of the badlands

But even if the Talibanisation of all Pakistan is a long way off, the danger the Taliban represents should not be understated either. It is strong not just in the Pushtun borderlands of Baluchistan, the Federally Administered Tribal Areas (FATA) and the North-West Frontier Province (NWFP), where Pakistan and Afghanistan blur along a disputed border. Early this month a Polish engineer was beheaded not far from the capital, Islamabad. This week the government bought a truce in an Islamist uprising in the Swat Valley, once a famous tourist spot in NWFP, by agreeing to adopt *sharia* law there. Pakistan remains half-hearted about fighting predominantly Pushtun militants. Even now, it seems, a part of its establishment sees the Afghan Taliban as a "strategic asset"—insurance against India's ambitions and against NATO's inevitable withdrawal.

To make up for Pakistan's lack of enthusiasm for this fight American forces in Afghanistan are continuing under the Obama administration to make increasing numbers of unmanned air raids in Pakistan. These raids appear to have been highly successful in killing Taliban and al-Qaeda suspects. But they are strategically misconceived. Whatever short-term battlefield advantage the raids bring pales in comparison with the long-term danger posed by the resentment they cause: a generation of poor young Muslims growing up in Pakistan feels bombarded by American bombs on one side and by fanatical Islamist propaganda on the other. To prevent the former from validating the latter, Mr Obama should stop the cross-border attacks right away.

Mr Obama may be tempted to take the "regional" scope of the conflict further. Doesn't victory in Afghanistan depend on resolving the disputed Afghan-Pakistani border; or even on solving Pakistan's dispute with India over Kashmir, which continues to provide a local source of intense grievance to

Muslims? Not really. To embroil the war with the settlement of such intractable disputes is to give an excuse for prevarication. The real solutions are more mundane even if they are difficult.

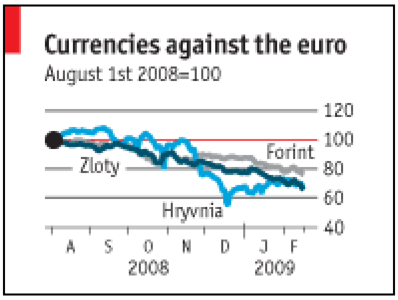
The war in Afghanistan will be won, if at all, by means of more troops on the ground (to reduce the dependence on air power and the civilian casualties it brings); through huge investment in development; and through piecemeal arrangements with local tribes and powerbrokers, including the Taliban. Pakistan, too, needs financial aid, to back up an attempt to integrate the tribal areas. Its government and army need constant reminding that Mr Zardari is right when he says that Pakistan’s battle with the Taliban is not being fought on America’s behalf, but in the interests of Pakistan itself.

Eastern Europe

Argentina on the Danube?

Feb 19th 2009
From The Economist print edition

Europe is facing nightmarish problems in its east. With help from the West, meltdown can be avoided



IF YOU mix East Asia from 1997 with Latin America in 2001, do you get eastern Europe in 2009? Already worried, financial markets are pricing in the likelihood that one or more of the ex-communist countries in the region will default on its debt.

The biggest weakness lies in a financial system that has combined badly run local banks with loosely overseen subsidiaries of Western ones. During the boom years, this system gobbled up credit from abroad, leading to yawning current-account deficits. Both kinds of banks now have souring loan books—the result of reckless lending, often in foreign currencies. Some local banks have failed; many of the foreign-owned ones now depend on their parents' willingness to keep financing them—and those parents have plenty of problems at home. The Greek government has told its banks to draw back from their lending in the Balkans. Austria's lending to eastern Europe is equivalent to about 80% of its GDP.

If finance is the immediate worry, the global downturn is causing plenty of other problems. Exports of manufactured goods to western Europe have plummeted; remittances from migrant workers employed there will also surely fall. Ukraine, dependent on exports of steel and coal to Russia, seems to have abandoned the deal it struck with the IMF only three months ago as part of a $16.4 billion bail-out. Latvia, also rescued by the IMF, is expecting a 12% fall in GDP this year. The collapse in output is likely to be as big as Asia's ten years ago—but with a twist. The Asian countries recovered thanks to export-led growth. Now the whole world is in a mess.

What can the governments do? In many places the policy levers look flimsy. Countries such as Poland and the Czech Republic have cut interest rates to help ease the pain—but this has sent their currencies tumbling, increasing the agony for households that have mortgages in Swiss francs or euros. Some countries have an extra problem of big external government debts (in Hungary's case, the gross figure is near 100% of GDP). Even those that could perhaps afford to run a counter-cyclical policy to offset the effects of the downturn are squeezing public finances—in part because they think that cutting deficits will help them reach the (presumed) safety of the euro zone.

For four countries—the three Baltic states plus Bulgaria—the strong euro is a problem; they have pegged their currencies to it. Some fear a repeat of the doomed struggle to keep Argentina's currency board afloat in 2000-01; or perhaps worse if one currency's collapse swamps others. As for help from abroad, the IMF can give instructions to individual countries, but it cannot run the whole region. The European Central Bank, which is not a lender of last resort even to banks in the euro zone, has been sniffy about lending to countries outside it.

Worse for some, much worse for others

A very nasty recession is inevitable, but regional catastrophe is not. For a start, talk of "eastern Europe" is imprecise. The woes of Kazakh banks or of Ukraine's public finances have little to do with the countries, mainly smaller, richer and better governed, that are already in the EU. If Ukraine defaults or (more likely) is forced to restructure its debt, it need not hurt others. Though the region has allowed startling imbalances to develop, foreign-exchange reserves are generally stronger than in Asia ten years ago; and there is less light-footed "hot money".

For the new EU members, there is also the prospect of help from the West. Their banking systems are far

more intertwined than Asia's were—and the foreign banks are less likely to walk away (see article). The Baltic countries have been bolstered by a Swedish guarantee covering Swedish banks that operate there. Although the EU and the ECB may not want to get involved in bigger bail-outs, they will have to. Even the most short-sighted west European politician will surely not send his neighbours into economic and political anarchy.

This is the most perilous period for east European countries since the collapse of the Soviet Union. People there are going to be a lot poorer and (justifiably) crosser. But it would take a bout of wilfully destructive protectionism and the demise of the EU's main institutions to turn that into disaster.

Economist.com OPINION LETTERS

On Brazil, banks, privatisation in Russia, broadband, Japan, Asia, London

Feb 19th 2009
From The Economist print edition

José Sarney

SIR – Your article about my political career ("Where dinosaurs still roam", February 7th) neglected to mention that for the past seven years a rival political group has controlled the state government of Maranhão in Brazil. During the past 40 years numerous governors of the state have belonged to other political groups, over which I had no influence. I have not stood in an election in Maranhão for 30 years. Therefore, I do not think it can be said that I control the state as a fief. I completely agree that the state of conservation of the city of São Luís is lamentable, but it is absurd to attribute this to me, as it is my political adversaries who have managed the capital for 20 years. Any reference to my political control is incorrect.

You wonder whether it is time for me to retire from public life, yet it is not in the Brazilian, or indeed British, tradition to limit a person's participation in public life on the ground of age. *The Economist* will be aware of how long Winston Churchill (64 years) and others such as David Lloyd George and Benjamin Disraeli remained in politics. Nor is there anything new in members of the same family participating in a country's politics. Examples in Britain include the Pitts and the Churchills and in the United States the Adams, Kennedy and Bush families.

As to having been the "accidental, and undistinguished" president of Brazil, this is not the judgment of the Brazilian people, who rank me third among former presidents in surveys. As vice-president I succeeded Tancredo Neves in accordance with the constitution. History will judge the role I played, but I am acknowledged as the president of the democratic transition, who summoned the constituent assembly and prioritised social development. This permitted a truly democratic society to flourish and paved the way for the election of a worker as Brazil's president in Luiz Inácio Lula da Silva.

Finally, the assertion that senators "answer" to me is baseless. They answer to the electorate, the constitution and legislation that punishes any behaviour inconsistent with their own independence.

José Sarney
President of Brazil 1985-90
President of the Federal Senate of Brazil
Brasília

Holding the board to account

SIR – It is right to sneer at the lack of humility shown by banking executives and workers after their obvious failings ("Looting stars", January 31st). But shouldn't some derision be aimed at the boards of directors at the banks? Executives and workers taking what they can, or taking risks to maximise their pay under a given employment agreement, is strictly a dog-bites-man story. It is just the nature of the beast, and the same aggressive qualities that prompt hubris in compensation can, if harnessed, benefit a company.

From the financial crisis itself to the ongoing compensation scandal, the real story is the bankrupt state of corporate governance in America's financial sector. The extent of the ineptitude and lack of will of directors to act in a fiduciary manner for their shareholders has been grossly exposed. So although the conduct of executives may be shameful, that of directors is arguably actionable.

Jonathan Moreland
Director of research
InsiderInsights.com

New York

Privatisation and mortality

SIR – The authors of a study claiming that mass privatisation led to increased mortality in Russia responded to your scepticism ("Mass murder and the market", January 24th) by asserting that they use "evidence rather than ideology" (Letters, February 7th). But although their article documents a correlation of privatisation and mortality at the country level, it provides no evidence for their theory that privatisation causes job loss.

In fact, the evidence contradicts that theory. In a forthcoming study in the *Economic Journal*, my co-authors and I find that privatisation does not systematically lead to large employment cuts. Our results, using data on nearly every manufacturing firm in four economies (Hungary, Romania, Russia and Ukraine), suggest that the employment impact of privatisation is usually positive, and where it is negative the magnitudes are small and statistically insignificant.

The estimated effects of foreign privatisation are almost always positive, large and statistically significant, implying 10-30% expansion of employment following acquisition. Even in the country with the most (in)famous mass privatisation, Russia, the estimated effects of both domestic and foreign privatisation on employment are positive.

John Earle
Upjohn Institute
Kalamazoo, Michigan
and Central European University
Budapest

Closing the digital divide

SIR – Writing sceptically about governments' stimulus plans for broadband was doubtless easier to do from a home where the children already have internet access ("Not so fast", January 31st). That is not how it is for the majority, including substantial numbers of people in mature countries. There is abundant research pointing to the social and economic benefits that come with access to the internet. It would be a great shame if the various global recovery packages under consideration are used to rebuild yesterday's infrastructure, without having built tomorrow's. A competitive economy will need universal broadband where speed exceeds 2 megabits per second. Without assistance, the digital divide stands to widen and we will all be poorer for it.

Sean Maloney
Executive vice-president
Intel
Santa Clara, California

Business methods in Japan

SIR – Your leader about poor management in Japan typifies the West's arrogant attitude to the Japanese ("Nothing to lose but their (restaurant) chains", February 7th). It reveals a complete lack of understanding of the structure of Japanese industry, the relationships that bind the network of suppliers, customers, distributors and banks and of the values that govern society as a whole. Even though maximum return on equity is not the one and only goal in Japanese business, in the long run the country will continue to do at least as well as the American or European economies. The Anglo-Saxon business model of maximising shareholder value has brought us the most severe crisis since the 1930s.

Heini Lippuner
Oberwil, Switzerland

SIR – I find it hilarious that you think "job cuts", "closing factories" and "shedding staff" are causes for optimism in Japan. Giving out pink slips may be interpreted as a sign of vibrant capitalism in America and Britain, but not in most other countries and definitely not in East Asia. Providing secure jobs to

employees is as important as raising shareholder value for firms in Japan, South Korea and elsewhere.

Cho Jin-seo
Oxford

The following letter appears online only

Asia's economies

SIR – Your leader on Asia's troubled economies advises Asian governments to "introduce structural reforms that encourage people to spend and reduce the need for them to save" ("Asia's suffering", January 31st). Is that the best you can do, 60 years after Keynes? Your statement displays a callous indifference of the consequences of natural calamities, or moral hazard, on populations near the base of the pyramid.

It also displays a refusal to consider the importance of nurturing the commons when around 1.5 billion people on this planet live on less than $1 a day, and around 4 billion on less than $2 per day. You did not consider the enormous structural changes that have occurred in recent years, such as the rise of enormously wealthy global communities, an energetic, affluent and peripatetic lot that flit effortlessly around the globe.

In yesteryear, those who had power and voice also bore the burden of *noblesse oblige*. I expect more from *The Economist*.

Ricky Surie
Forest Hills, New York

Flood warning

SIR – Bagehot listed the various nicknames given to London over the years, including Manhattan-on-Thames, Londonistan and Londongrad (January 31st). Given climate change and rising sea levels, in the future London will probably be better known as London-under-Thames.

Duncan Green
London

Pakistan

In the face of chaos

Feb 19th 2009 | ISLAMABAD AND LAHORE
From The Economist print edition

How Pakistan's army is failing, and what America must do, to crack down on rampant Islamist insurgencies in the region

Reuters

IN A rooftop restaurant overlooking the old Mughal city of Lahore, Richard Holbrooke dined on February 11th with a group of liberal Pakistani businessmen, human-rights campaigners and journalists. He had come, midway through his inaugural tour as America's special representative for Afghanistan and Pakistan, with a heavy question. Against a rising thrum from the narrow streets of the red-light district below, Mr Holbrooke asked: "What is the crisis of Pakistan?"

Well might he ask. Pakistan, the world's sixth-most-populous country and second-biggest Muslim one, is violent and divided. A Taliban insurgency is spreading in its north-west frontier region, fuelled partly by a similar Pushtun uprising against NATO and American troops in Afghanistan (see article). Some 120,000 Pakistani troops have been dispatched to contain it, yet they seem hardly able to guard the main road through North-West Frontier Province (NWFP). On February 3rd NATO briefly stopped sending convoys through Pakistan—which carry some 75% of its supplies to Afghanistan—after Pakistani militants blew up a road bridge in NWFP. A related terrorism spree by the Pakistan Taliban and allied Islamists, including al-Qaeda, whose leaders have found refuge in the semi-autonomous tribal areas of the frontier, has spread further. Pakistan has seen some 60 suicide-bomb blasts in each of the past two years.

Parts of Pakistan's vast and thinly populated western state, Baluchistan, are also in revolt. And fears for the security of Karachi, a rowdy port city of 15m, from which a militant group close to the army, Lashkar-e-Taiba (LET), launched an amphibious assault on Mumbai last November, are rising. Faced with these threats, the central government in Islamabad, a coalition led by the Pakistan People's Party (PPP), and presided over by its leader, President Asif Zardari, is struggling. Cobbled together a year ago, after an election that swept the former army-backed government from power, it is short on competence and dogged by allegations of corruption. It has no one deemed fit to be finance minister. An unelected banker, Shaukat Tareen, holds the job, pending his expected election to Pakistan's upper house, or Senate, in March. Another unelected friend of Mr Zardari runs the interior ministry.

After a decade of army rule, it was inevitable that the new civilian government would take time to bed down, even if the times were less troublesome. Yet unfortunately, as always during Pakistan's bouts of civilian rule, the government has been beset by feuding. In a popular move, Mr Zardari pitted himself last year against the country's former army ruler, President Pervez Musharraf, forcing him to resign last August. Almost at once, Mr Zardari and his erstwhile ally, Nawaz Sharif, who leads the Pakistan Muslim League (Nawaz) party, or PML(N), fell to blows. Mr Zardari has been leaning on the country's Supreme Court to disqualify Mr Sharif from contesting any elections, because of a conviction some years ago on a hijacking charge. In the same throw, the judges may force his brother, Shahbaz Sharif, to step aside as

chief minister of Punjab.

Mr Zardari, who inherited the party from his murdered wife, Benazir Bhutto, and fears that he too will be assassinated, is almost as unpopular as the detested Mr Musharraf. A survey released by the International Republican Institute in December found that only 19% of Pakistanis wanted him for their leader; 88% thought the country was heading in the wrong direction. It is, though Mr Zadari is mostly not to blame. After two years of political turmoil and spreading violence, the economy is moribund. The textiles industry, which accounts for about half of Pakistan's industrial jobs and foreign-exchange earnings, has been pole-axed by gas and electricity shortages. A third of the textile factories in Punjab are said to have been shut down. In November, faced with the prospect of defaulting on its external debt, Pakistan had to return to the International Monetary Fund for a $7.6 billion bail-out.

The Taliban insurgency is a particular worry. It is fiercest in the tribal areas, which the Taliban more or less rule, but is spreading throughout NWFP and touching Punjab in places. On February 16th NWFP's government, which is led by the Pushtun-nationalist Awami National Party, vowed to implement *sharia* law in the district of Malakand, where over 1,000 civilians are reported to have been killed recently by army shells or by beheading at the hands of the local Taliban. This may or may not placate the militants' leader, Mullah Fazalullah. His black-turbaned gunmen already control most of the area, including its lovely tourism region of Swat. Fittingly, Pakistan's tourism ministry is currently held by the Jamiat Ulema-e-Islam-Fazl (JUI-F), an Islamist party that has sown hundreds of radical *madrassas* across NWFP. The ministry has vowed to correct the "immoral practices" of foreign tourists in Pakistan, assuming it can find any.

Holding back the tide

In Lakki Marwat, a district close to two thoroughly Talibanised tribal areas, North and South Waziristan, a hereditary Pushtun chief, Anwar Kamal, describes his efforts to hold back the militant tide. He and other chieftains have deployed a tribal army of 4,000 bearded Marwats along their 110km (70-mile) Waziristan frontier. In recent weeks they have fought several battles against the forces of Baitullah Mehsud, a Taliban commander who controls much of South Waziristan and is alleged to have supplied the killers of Ms Bhutto. Mr Kamal, who is also a senior member of Mr Sharif's party, says: "We are heavily loaded with heavy weapons, from top to toe with anti-aircraft guns, anti-tank guns and mortars. It is the fashion these days, heavy weapons." And yet, with perhaps 15% of his tribesmen openly supporting the Taliban, "For how long can I control my area?"

Security in Peshawar, NWFP's always-wild capital, home to gun-runners, dope-peddlers and, during the days of the anti-Soviet *jihad* in Afghanistan, Osama bin Laden, is deteriorating. Taliban bosses and bandit gangs—the Islamists' fellow travellers—are said to be renting houses in the city. Accordingly, wealthy Peshawaris are moving out. Fugitives from the frontier—where over half a million are estimated to have been displaced—have descended on the city. Two Afghan diplomats and one Iranian were recently abducted in Peshawar; the American consul was lucky to survive a murder attempt there last year. Last week a Taliban gang from Khyber circulated a video of an abducted Polish engineer, Piotr Stanczak, having his head sawn off with a butcher's knife. They had taken him hostage in Attock, a district of Punjab only 80km from Islamabad. On the day of his dinner in Lahore, Mr Holbrooke had also visited Peshawar—and a member of NWFP's government had been killed there by a roadside bomb.

Foreign diplomats in Islamabad sound increasingly despondent. One says: "The more effort we've put into this place, the worse it's got." The rate at which Mr Musharraf's few achievements have crumbled to dust is shocking. Bolstering the economy, mismanaged by Mr Sharif, was one. An ambitious package of local government reforms, establishing elected mayors to run the district-level bureaucracy, was another. In NWFP this system, perhaps unfairly, has been blamed for ushering in the Taliban, and is now being hobbled. Other provinces are expected to do likewise.

More depressing is the demise of Mr Musharraf's biggest triumph, a detente with India. A bilateral peace process, launched in 2004 by Mr Musharraf and Atal Behari Vajpayee, India's then prime minister, had brought the two countries closer than at any time in their painful history. Even a settlement of the dispute over divided Kashmir seemed possible. But in 2007 Mr Musharraf's attention wandered to crushing his democratic opponents, and the initiative drifted. In November, after the attacks in Mumbai in which over 170 were killed, India put it on hold.

On February 12th Pakistan's government admitted, for the first time, that the atrocity in Mumbai was LET's doing. It also vowed to try the plot's ringleaders, including six LET members already in its custody. This was encouraging. But it is much less than the eradication of anti-India militancy that India demands.

The generals' game

With all this bad news, it is tempting to wonder whether Pakistan could be heading for a meltdown—a Taliban takeover, perhaps. Even Mr Zardari has admitted that the militants hold "huge amounts of land". Yet the headlines give a distorted picture of the place. Most Pakistanis are moderate. That is why, in last year's unusually unrigged election, a coalition of Islamists, including JUI-F, did miserably, losing power in NWFP and Baluchistan. And though Punjab, where 60% of Pakistanis live, is LET's heartland, it is more orderly than several big Indian states, and richer.

To revert to Mr Holbrooke's question, Islamist militancy is not the only crisis of Pakistan. In fact, as America's envoy was emphatically told over his dish of spicy lentils, it is partly a consequence of the country's abiding affliction: the refusal of Pakistani generals to abandon a national-security policy that they have presumed to dictate, with disastrous consequences for Pakistan and its region, for six decades. It was founded on a belief that Hindu India is Pakistan's mortal enemy, and on an ambition to drive India from Kashmir. For a rear-base—or "strategic depth"—against the threat of an Indian invasion, the army has sought to control Afghanistan; thus it helped propel Mullah Omar and his turbaned friends to power there in the 1990s. In fact, Pakistan's generals have consistently employed Islamist militants as proxies, from 1947 onwards.

By toppling Mr Sharif in 1999, Mr—then General—Musharraf followed a long tradition of army coupsters seizing power to "save the nation". However, by turning his back on the Taliban in 2001, he promised a new track. And in extending his hand to the Indians, he seemed to show that he was serious. At America's request, Mr Musharraf shifted troops from the eastern border to secure the north-west frontier. At the same time—and especially after Islamist assassins twice tried to kill him in 2003—he vowed to eradicate militancy in Pakistan, including some 40-odd jihadist groups with links to the army's Inter-Services Intelligence (ISI) agency. For this reason, liberal Pakistanis who were sceptical of Mr Musharaf's other promises—to improve Pakistani democracy, for example—supported him. Yet there were always reasons to doubt that a genuine policy shift was under way. Banned militant groups, including LET, re-emerged under new names. Militant leaders, such as LET's Hafiz Saeed, remained at large. After Mumbai, alas, these doubts have proliferated.

The alacrity with which the Pakistani army rushed to embrace the threat of an Indian military reprisal was remarkable. In fact, India did not explicitly threaten any such thing. And Mr Zardari, as a conciliatory gesture, offered to send the head of the ISI, Lieut-General Ahmed Shuja Pasha, to Delhi. Yet Pakistan's generals, having scotched that offer, leapt to battle-stations. They shifted several thousand troops from the north-west to the eastern border. Pro-army media commentators, spewing anti-India propaganda, whipped up the nation for war. In a briefing to Pakistani journalists, a senior ISI officer said that the Taliban had assured the army of its support in the event of a war with India. He referred to their leaders, including Mr Mehsud, the alleged killer of Ms Bhutto, and Mr Fazalullah, as "patriotic Pakistanis".

Tensions have since eased. But a senior ISI officer, giving a rare interview to *The Economist* last week, says he still regrets that a "strike division", trained to punch into India, had been posted to the north-west frontier: "Never in my lifetime will we ever have peace with India."

Hapless on the frontier

Doubts about the army's commitment to securing the north-west have also been persistent. In the aftermath of America's 2001 invasion of Afghanistan, Pakistan arrested over 600 al-Qaeda fugitives, but did nothing about the Taliban, who poured into Baluchistan and the tribal areas. From the start, the army believed America and its allies would swiftly withdraw from Afghanistan, opening the way for its former proxies to return to power. When America's attention wandered to Iraq, the generals became doubly convinced of this. To hasten the Westerners' departure, they are alleged—especially in Kabul—to have helped the Taliban launch their ongoing insurgency in Afghanistan. Around the same time, after entering the tribal areas to hunt down al-Qaeda, the Pakistanis found themselves fighting a billowing Pushtun insurgency of their own.

To pay for its campaign costs, the army has received some $10 billion from America. Yet its efforts have been so hapless that many accuse it of not really trying. It has lost over 1,500 men, for little obvious gain. The civil administration along the frontier, which was always weak, has collapsed. The tribal elders whom the government had used as interlocutors have been murdered by militants (who are mostly youngsters; Messrs Mehsud and Fazalullah are in their early 30s). The army seems demoralised. Designed to fight tank-battles against Indians, it is ill-equipped to take on Pushtun guerrillas in their mountainous terrain. Its troops are disinclined to kill their Muslim countrymen in a war that few Pakistanis support. This is a serious problem. It also means Pakistan feels bound to keep collateral damage to a minimum. The army claims that an operation against Mr Mehsud's men in South Waziristan was ended last year after the militants corralled themselves in a thickly populated area. Instead of scattering the militants, the army made a deal with them.

Reuters

Pro-Taliban, and anti-camera, in Swat

In return for their promise not to fire on the troops garrisoned among them, not to play host to al-Qaeda and not to fight in Afghanistan, Mr Mehsud and his confrères in North Waziristan have been left with the run of their areas. The army aims to make similar deals with militants in Bajaur and Mohmand, where it has been fighting fierce battles in recent months. That would leave it free, it hopes, to launch further operations in Orakzai, a pristine Taliban haven, and Khyber. But piecemeal operations of this kind have merely shunted al-Qaeda and other militants around the tribal areas. And the army's ceasefire deals have often been flouted; Mr Fazalullah has torn up at least two of them. Worse, suspicions that the ISI, or at least some of its officers, are still in cahoots with their jihadist enemies persist. Last year America, whose trust in the Pakistani army's good faith was almost a testament of its belief in the war on terror, began launching frequent missile strikes on the tribal areas. At least 30 people were said to have been killed in a strike in the Hurram tribal area on January 16th.

This strategy is reported to have been effective. By one—possibly wishful—estimate, American missile strikes in Pakistan have killed 11 of al-Qaeda's 20 commanders in the past six months. But they have also boosted anti-Americanism among Pakistanis, especially within the army. Senior ISI officers attribute most of their troubles in the tribal areas to anger over the American strikes. They also accuse India of giving "significant" support to their Taliban enemies there. On both counts, this seems unlikely. Moreover, recent reports allege that the unmanned drones being used in the strikes are in fact based inside Pakistan, which would suggest a certain Pakistani complicity in the ploy. Nonetheless, as a symbol of America's mounting mistrust of its vital Pakistani allies, the policy needs better management. One suggestion is that a joint Afghan-Pakistani-American counter-terrorism agency might be set up to do it.

Presumably this is one of the problems that Mr Holbrooke has been hired to solve. His brief is certainly daunting. Unless Pakistan's army can be persuaded to undergo a "strategic renaissance", in the phrase of Lieut-General Talat Masood, a Pakistani military pundit, it may be unwilling or unable to deny the use of its north-west frontier to the Afghan and Pakistan Taliban. It will not, in a month of Fridays, be bulldozed into complying with America's demands. "You can't insult a country into co-operation," says General Masood. Besides stern words, Pakistan's army will therefore require even more American money and equipment, especially counter-insurgency kit, such as helicopters and night-vision gear, which it has long demanded. It will also require America to allay the army's fear of encirclement by a pro-India regime in Afghanistan. Meanwhile, America needs to stand up for Pakistan's democratic leaders, who are on its side. Mr Zardari and Mr Sharif both say they want peace with India and an end to ruinous militancy. Neither is a friend to the army.

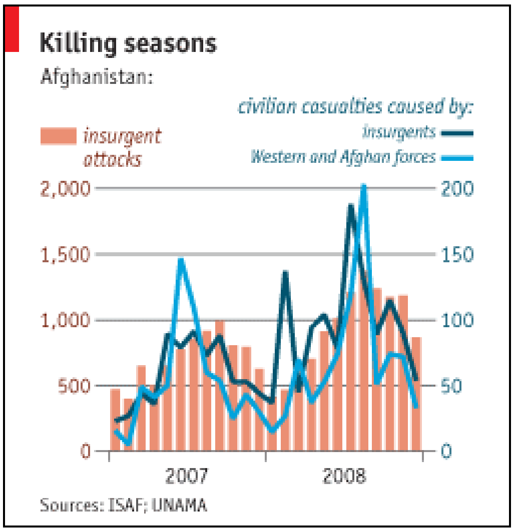
Finally, America and NATO must convince the Pakistanis that they mean to stick it out in Afghanistan until the fledgling state can stand up for itself. Some ISI officers concede that NATO will remain in Afghanistan longer than the army had expected ("maybe another 15 to 20 years"). But none seems to believe it can stabilise the place; and this remains NATO's improbable task. Without better help from Pakistan, it may not succeed. But even with this help, as the Pakistanis know, NATO may fail.

Afghanistan and Pakistan

Boots on the ground

Feb 19th 2009 | KABUL
From The Economist print edition

America is sending more troops and helping build a bigger Afghan army, but will still struggle to defeat the Taliban



THE big Antonov aircraft lumbered over the snow-clad mountains, landed at Kabul airport and, like a mythological whale, opened its great jaws to disgorge a consignment of Russian-designed attack helicopters. It might have been a scene from the Soviet occupation of Afghanistan, except that nowadays it is America that is providing the refurbished Mi-35 Hind helicopters that once terrorised the Afghan countryside, and training (or retraining) their Afghan crews. Many are veterans of the Soviet-backed forces; the commander of Afghanistan's air corps is a former MiG-21 pilot.

Such ironies will give ammunition to the many doubters who say that America is repeating the errors of the Soviet Union. Like the Soviet empire (and the British one before it), it has failed to understand that controlling Afghanistan is much harder than invading it. And like Soviet leaders, critics say, President Barack Obama is now reinforcing failure by sending thousands more troops to confront an insurgency organised from across the border in Pakistan. The White House on February 17th announced that 17,000 more troops would join the existing 65,000 Western troops "to stabilise a deteriorating situation in Afghanistan, which has not received the strategic attention, direction and resources it urgently requires."

Despite the weight of history and the yearly deterioration in security, American commanders remain convinced that the war is "winnable". Unlike the anti-Soviet mujahideen, they argue, the Taliban, al-Qaeda and their allies do not have the support of a superpower. America has broad international backing for its actions, and still enjoys a good measure of support among ordinary Afghans. So for now American pilots and their Afghan charges dominate the air, with little fear of being shot at with anti-aircraft missiles of the kind America once gave the mujahideen.

Helicopters are the workhorses of the Afghan campaign, allowing troops to move with less risk of ambush or bombs; insurgents tend to scatter at the sight of attack helicopters. Under American tutelage the Afghan air corps has grown from four aircraft that had somehow survived the civil war of the 1990s and American air strikes in 2001 into a modest fleet of 32 aircraft—propeller-driven Antonov transport planes, Mi-17 transport helicopters and, more recently, the Mi-35 attack helicopters. Afghan pilots cannot yet fly by instruments at night or in bad weather; a helicopter crash in January killed one Afghan army commander and several others. But the air corps has been busy moving Afghan troops into battle zones. By 2016 it is expected to grow to more than 120 aircraft, perhaps including some light attack jets, at a total cost of about $5 billion. "Building an air corps in the middle of a war is like building an aircraft in mid-flight," says Brigadier-General Walter Givhan, commander of the American training team.

The Afghan army is also being built in mid-battle, expanding from the current 80,000 troops to 134,000 (plus embedded Western troops) by 2011. Afghan soldiers are respected by Western commanders as tough fighters, and are well-liked by most Afghans as members of one of the few functioning national institutions.

A wholesale review of America's policy in Afghanistan, and across the border in Pakistan, is due to be completed in the coming weeks. In the short term, NATO hopes that with more Afghan units and extra American troops, perhaps helped by the possible short-term deployment of up to 10,000 more European forces, it will be able to secure enough of the populated areas in the restive Pushtun belt to ensure a credible presidential election in August. Commanders say the American reinforcements will be used to improve security in provinces surrounding Kabul, protect the ring road that connects Afghanistan's cities

and, above all, to reinforce NATO's faltering effort in the south of the country. British and Canadian forces in Helmand and Kandahar provinces respectively have been hard-pressed since 2006. The extra troops will also establish greater control of the open desert border with Pakistan in the south; they will seek to interdict fighters and weapons being smuggled into Afghanistan and drugs being taken out of it.

This may lead to a rise in violence, at least in the short term. But commanders argue that, with more boots on the ground, they will have less reason to use the air power which has contributed to a sharp rise in civilian casualties (see chart) and has raised tensions with the Afghan government. The United Nations recorded the deaths of 2,118 civilians in the conflict last year, 39% higher than in 2007 and the highest yearly toll since the fall of the Taliban. Of these, 55% were attributed to the Taliban and other "anti-government elements", and 39% to Western and Afghan forces.

Few are predicting an Iraq-style improvement in security. The sanctuary enjoyed by insurgents in Pakistan gives them the ability to fight more or less indefinitely. Indeed, there is much debate over the extent of Pakistan's co-operation with NATO (or, in the view of sceptics, of its double game). Senior Americans say cross-border communication has improved, particularly in the east (eg, along the border with Kunar province), but some senior Afghans think this is a sham. They note that the most important havens—in Waziristan and in Baluchistan—are untroubled by Pakistani forces; Taliban leaders allegedly meet freely in Karachi. For one well-placed Afghan, "Pakistan is the political wing of the Taliban."

Fighting Afghan with Afghan

As insurgents come under pressure from NATO in the south, they may shift their attacks to areas that are less defended; the Dutch in Uruzgan, a relative success story of late, worry that the Taliban will move into their area as the Americans push into Helmand and Kandahar. Counter-insurgency requires large numbers of troops and policemen (which in Afghanistan are weak, corrupt and often drug-addled). Abdul Rahim Wardak, Afghanistan's defence minister, says his army needs to be much bigger than the planned 134,000. Almost everybody would agree with him. Iraq, smaller than Afghanistan in terms of land area and population, has over 267,000 troops.

One problem, though, is that the Afghan army cannot grow any faster because of a shortage of literate recruits for the officer corps. Another problem is money; Afghanistan is too poor to afford even the forces it now has. But Mr Wardak says that is the wrong way to look at the problem. As thousands more Western soldiers prepare to move into his country, he says: "Building, equipping and training the Afghan army is much more economical than the deployment of foreign troops."

California's crisis

The ungovernable state

Feb 19th 2009 | LOS ANGELES
From The Economist print edition

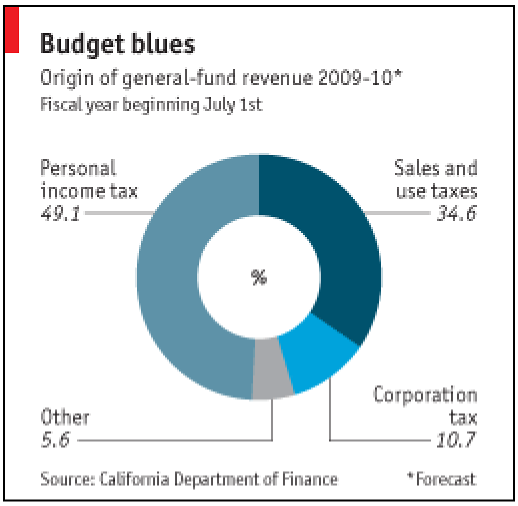
California makes Washington, DC, look like a model of fiscal probity

Ronald Grant Archive

IT TURNS out that the only way to negotiate a budget for the world's eighth biggest economy is to issue politicians with toothbrushes and lock them in a building. California's legislators have spent the past three months debating how to fill a $42 billion fiscal hole. Officials have given warning of fiscal Armageddon, bureaucrats have been forced to take unpaid leave and Arnold Schwarzenegger, the state's governor, has accused members of his own party of innumeracy—all to no avail. But a few nights of indoor camping seems to have concentrated minds.

As *The Economist* went to press a Republican senator appeared willing to cast a decisive vote in favour of the budget, which requires the approval of two-thirds of legislators. The process has been messy, but revealing. Investors sometimes say that recessions help to reveal flaws in business models. This one has exposed deep cracks in the state of California.

The immediate cause of the budget crisis can be traced to Wall Street. California depends on income taxes for almost half of its revenues (see chart). Its tax code is so progressive—that is, rich-soaking—that in 2006 the top 1% of earners paid 48% of all income taxes. Since the wealthy derive much of their income from bonuses, capital gains and stock options, the state's fortunes rise and fall with the markets. California's economy is as wide and deep as the ocean, but much of its revenues come from froth. That froth has simply blown away.



The sudden loss of revenues would not be such a problem if public spending had been kept under control. But whenever the state receives an "April surprise" of unexpectedly high income-tax receipts, as it did during the roaring middle of this decade, it ratchets up spending on public services. This is largely the fault of the liberal Democrats who dominate both houses of the legislature. But not entirely. It was voters, for example, who by means of ballot initiatives insisted that the state spend more money on schools and stem-cell research.

Pet conservative causes have forced up spending too. In the past 20 years the number of state prison inmates has risen from fewer than 80,000 to more than 170,000.

Yet the biggest enemy of fiscal responsibility is California's political culture. Thanks to a bipartisan yen for gerrymandering, virtually all electoral districts are safely Democratic or safely Republican. So the only elections that count are the primaries, which tend to favour the pure of ideology. Republican candidates promise never to raise taxes; Democrats pledge allegiance to the environmental movement and the teachers' unions. Not surprisingly, the politicians generated by such a system agree on little. "They belong to different universes," says Allan Hoffenblum, a Republican consultant.

One of the few moderates is Abel Maldonado, the Republican state senator who appeared most likely to break with his party's anti-tax orthodoxy. In return for supporting tax increases Mr Maldonado wants support for a ballot initiative that would reform the primary system, making it more hospitable to people like him (ah, to hold the deciding vote at such a time). He may get his way, although his initiative is probably doomed. Every special-interest group that benefits from the current system, of which there are many, would fund the campaign against it.

A deal on the budget would avert impending catastrophe. California has already delayed tax refunds and payments to state contractors. Work on roads and bridges has virtually halted. Cities and counties are preparing to sue the state government for money owed to them. Earlier this month Standard & Poor's downgraded California's bond rating, which was already as bad as Louisiana's, to the worst in the nation.

Even if a budget is signed it will not be the end of the matter. The books will not balance unless California's voters permit the state government to raid programmes for children and the mentally ill which they had previously created through ballot initiatives. Voters must also approve changes to school funding and permit the state to borrow $5 billion against the future proceeds of the lottery. If they fail to do so—and the lobbying against some of the changes may be fierce—taxes will have to rise further and the budget may have to be reopened.

The mess in its biggest state is bad news for the nation. As he signed his stimulus bill this week Barack Obama declared "the beginning of the end" of the recession. Yet if California's budget passes, one in eight Americans will suffer a mood-lowering rise in their sales and income taxes. They will pay almost twice as much to register their cars, and 12 cents per gallon more to fill them up. Take that, Mr Obama.

The foreclosure plan

Can't pay or won't pay?

Feb 19th 2009 | WASHINGTON, DC
From The Economist print edition

The president's team wades into a debate over what is driving foreclosures

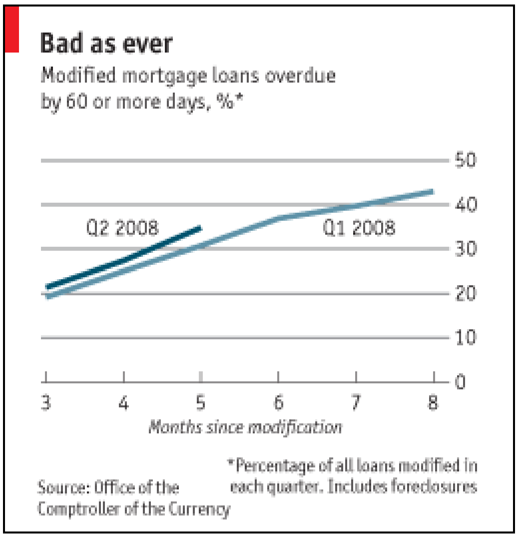
NO PART of the financial crisis has received so much attention, with so little to show for it, as the tidal wave of home foreclosures sweeping over America. Government programmes have been ineffectual, and private efforts not much better.

Now it is Barack Obama's turn. On February 18th he pledged $75 billion to reduce the mortgage payments of homeowners at risk of default. Lenders who help people to refinance their mortgages will receive matching subsidies from the government. These could reduce a borrower's monthly payments to as little as 31% of their income, and last for up to five years.

Firms that service mortgages held by investors will also receive fees for successful modifications. As a stick, Mr Obama reiterated his intention to alter the bankruptcy code so that courts can reduce mortgage principal. The details will depend on negotiations with Congress.

Some 5m homes have entered foreclosure in the past three years. Credit Suisse estimates that over 9m more will enter the process in the next four years. (In normal times, new foreclosures run at fewer than 1m a year.) Mr Obama predicts his plan will prevent up to 4m foreclosures. In a separate initiative, up to 5m borrowers will be able to refinance their mortgages at lower rates even if their equity is less than the 20% usually required by Fannie Mae and Freddie Mac, the now nationalised mortgage agencies.

Previous, less ambitious, efforts have flopped. George Bush's first plan aimed to help up to 240,000 delinquent subprime borrowers refinance their debts into government-backed fixed-rate mortgages. Only 4,000 did so. A Democrat-inspired $300 billion plan to guarantee up to 400,000 mortgages attracted just 517 applications, as lenders balked at the requirement that they first write down the principal. Private-sector programmes have achieved higher numbers, but their success is mixed. Of 73,000 loans modified in the first quarter of last year, 43% were again delinquent eight months later (see chart).



Mr Obama's chances of being any more successful depend on whether his team has correctly diagnosed what is driving the wave of foreclosures. Is it that homeowners cannot afford to pay; or is it that they are declining to do so, because their homes are now worth less than their mortgages, the phenomenon known as negative equity?

Both factors play a part, but economists are divided on their relative importance. One school thinks that, even in cases of negative equity, most homeowners will not default if they can afford the payments—not least because defaulting will wreck their credit records. A second school believes that once the home is worth less than the mortgage, homeowners have a significant incentive to walk away even if they can make the payment, since in many states lenders cannot then pursue them for the shortfall.

Mr Obama's advisers were drawn to the first school, in part by a Federal Reserve Bank of Boston study that found that when home prices fell 23% in Massachusetts between 1988 and 1993, only 6.4% of borrowers with negative equity ended up in foreclosure. The authors concluded that most such borrowers felt what they got from their home was still worth the payment. The advisers were also influenced by the Federal Deposit Insurance Corporation's apparent success in reducing the payments of delinquent customers of IndyMac, a failed bank. In a matter of months, 10% of the bank's 56,000 seriously delinquent borrowers had their payments reduced to 38% or less of income.

But others question the likelihood of success without reducing the principal. Edward Pinto, an independent financial industry consultant, estimates that 20% of borrowers with negative equity went to foreclosure in the past three years, in part because they started out much less creditworthy than their counterparts in Massachusetts two decades ago.

If negative equity is the real problem, principal will have to be reduced to stem the foreclosures. But lenders are reluctant: they worry that many homeowners who can afford their payments will choose to default, or that investors in the loans will sue them. With house prices still falling, many borrowers would soon have negative equity again. And the write-downs, whether voluntary or court-ordered, could destroy the lenders' capital. Aggregate negative housing equity is thought to top $500 billion. The government could absorb some or all of this, but at an astronomical and politically unpalatable price.

In truth, both lower payments and lower principal would help reduce foreclosures. At present, banks aren't doing much of either. Last month Communities Creating Opportunity, a non-profit group in Kansas City, Missouri, invited representatives of Bank of America and Countrywide to negotiate loan modifications with local customers. Damon Daniel, an organiser, says none of the 16 who applied got a write-down, though some might have their mortgages converted from an adjustable to a fixed interest rate.

Leslie Kohlmeyer and her husband fell behind on their payments two years ago when his construction business dried up. He eventually found new work and they resumed payments, but could not pay their arrears. Three days after Christmas, Countrywide notified them of foreclosure. Ms Kohlmeyer went to Mr Daniel's event, where a Countrywide official arranged to suspend the foreclosure; her arrears were added to the loan balance, and her monthly payment went up by $20. She thinks she'll be fine. Unless either she or her husband lose their jobs.

The politics of the census

Who counts?

Feb 19th 2009 | WASHINGTON, DC
From The Economist print edition

Another cabinet casualty revives a quarrel about the census

WHEN the Democrats won control of Congress two years ago, Senator Judd Gregg, a Republican from New Hampshire, caused them a fair bit of trouble. He kept slipping amendments into bills to give George Bush the power to cut lawmakers' pet projects. Harry Reid, the leading Democrat in the Senate, accused him of trying to "mess up" legislation. Mr Gregg replied: "I don't think I came here to be a potted plant."

The fear of being treated as a floral decoration may be what prompted Mr Gregg last week to go back on an agreement to become Barack Obama's commerce secretary. Having accepted the job, he realised that he did not agree with the president's policies. He said it would be hard to be part of Mr Obama's team but not "110% with the team". He cited two disagreements.

The first was fiscal conservatism. Of the stimulus bill that Mr Obama signed on February 17th, Mr Gregg said: "With a deteriorating budget situation, we cannot afford a proposal that will saddle future generations with massive amounts of debt with little to show for it in return."

His other quarrel concerned the national census, which for some reason falls under the Commerce Department. When Mr Obama nominated Mr Gregg, black and Hispanic Democrats complained that he could not be trusted to run a fair census in 2010. In previous years he tried to cut the money for the census. He also voted for a Republican budget that sought to axe the entire Commerce Department.

So Mr Obama let it be known that the organisers of the census would report to (later softened to "work with") the White House. Seeing his authority undermined before he even began, Mr Gregg thought better of giving up his Senate seat. Mr Obama must now find a third nominee. (His first choice, Bill Richardson, the governor of New Mexico, withdrew amid the whiff of scandal.)

The census is controversial because so much depends on it. A big chunk of federal money gets shared out among local communities by population. The census determines how many representatives a state sends to Congress, and therefore how many votes it wields in the Electoral College that picks the president. Electoral boundaries are also redrawn to reflect shifts in who lives where. So accuracy is essential—but also elusive. Homeless people and illegal immigrants, for example, are hard to count.

By and large, Republicans prefer the traditional method of going door-to-door and counting real people. Many Democrats think this undercounts ethnic minorities, not to mention the homeless; both groups tend to vote Democratic. Some want to see statistical sampling used to adjust the count. Republicans think this is an invitation to political manipulation, especially if Mr Obama's ferociously partisan chief of staff, Rahm Emanuel, has anything to do with it. A decade ago the Supreme Court ruled that statistical sampling could not be used when redrawing the borders of districts that elect congressmen. But it could perhaps be used for local electoral districts.

Some politicians, led by Carolyn Maloney, a New York Democrat, think the Census Bureau should be an independent agency, insulated from partisan interference. For their part, the head-counters are working on ways to improve their reckoning. Census workers are being taught, for example, to look for clues that a house has two families living in it, such as an extra letter box or electricity meter. Care is to be taken to include minorities. The Government Accountability Office, a non-partisan watchdog, says this "should position the [Census Bureau] to address the undercount". It will not end the squabbling.

Small homes

Very little house on the prairie

Feb 19th 2009 | LULING, TEXAS
From The Economist print edition

A new vogue for little living

Tiny Texas Houses

Squeeze right in

SEVERAL years ago Brad Kittel was living in the small town of Gonzales, Texas, running an architectural-antiques shop and feeling restless. He had the largest collection of antique door hardware in the country, and a warehouse full of salvaged material. But it was not shifting. So in 2006 he started Tiny Texas Houses, a building operation based in the appropriately tiny town of Luling, as a way of showing off his wares.

One of Mr Kittel's current projects is a custom-built Victorian-style farmhouse with a green exterior. Most of the house is to be made of salvaged materials. It will have a full kitchen and bathroom, a loft big enough to sleep in, and a roomy living area with a vaulted ceiling. At 350 square feet (33 square metres), this is a fairly capacious model. Some of his tiny houses are half that size.

The idea is to offer a greener and cheaper alternative to the dread McMansion. And Mr Kittel is not alone. The Small House Movement has been around for years, encouraging people to think about how much house they really need. But lately it has attracted more attention. "It seems like a perfect convergence of a bad housing market meeting a bad economy and more awareness about global warming," claims Jay Shafer, an enthusiastic advocate. His Tumbleweed Tiny House company sells small ready-made houses as well as plans for slightly larger ones. Its teensiest model, the XS-House, measures 65 square feet; ready-made, it costs $37,000. For several years, the company survived on a sale here and there. Lately, says Mr Shafer, interest has risen.

In one sense tiny houses are not a novel idea. Plenty of people live in small spaces because they cannot afford larger ones. And affluent Manhattanites could get lost in a 500-square-foot apartment. But the average American home is pretty big. In 1980, according to the National Association of Home Builders, the median single-family home sold was 1,570 square feet. By 2005 that had expanded to 2,235 square feet.

The indications now, though, are that the trend is to scale back. According to the Census Bureau, the median size of home starts dropped to 2,114 square feet in the fourth quarter of 2008, down more than 100 square feet from the first quarter of the year. And 100 square feet is a significant slice of space. Mr Shafer's whole house is about that size.

Louisiana's Bobby Jindal

The hope of the party

Feb 19th 2009 | NEW ORLEANS
From The Economist print edition

A contender for the White House?

WHEN Bobby Jindal appears on national television to deliver the Republican response to Barack Obama's first address to Congress on February 24th, not many people in Louisiana will be paying attention. After all, it will be Mardi Gras, a local holiday celebrated with passion, and plenty of libations.

Outside Louisiana, however, Republican leaders will be watching closely to see if Mr Jindal, who a month ago marked his first year as the governor of one of America's poorest and most troubled states, is the man they hope he is: the redeemer of their hard-pressed party.

He could just be. Mr Jindal is noted for his interest in policy, which makes him an effective counterpart to Mr Obama, whom he openly admires. Like Mr Obama, Mr Jindal is quick on his feet. And his Indian-American ancestry helps inoculate Republicans against the charge that theirs has become a party of, and for, white people.

Mr Jindal's recent fund-raising forays to other states—including Iowa, which every four years holds the crucial first presidential caucus—have raised some eyebrows at home. Few buy his line that he has the job he wants already, and that he is merely raising cash to fend off potential challengers three years hence. His ambition is well known, and most people think he is laying the groundwork for a run at the presidency in 2012.

It is too early to judge Mr Jindal's tenure as governor; and it is unlikely that his record will be the primary yardstick in determining his political prospects. That said, it is still worth looking at, and while the early returns are mostly favourable, they also throw up a few question-marks.

Mr Jindal had a couple of clear victories in his first year. He championed ethics reforms aimed at improving Louisiana's sorry image, and exuded competence during the twin hurricanes that threatened the state in his first storm season. Sceptics note that the storms were not nearly as nasty as Katrina or Rita, and the ethics changes may well be little more than window-dressing. But he still gets some credit.

On the other hand, Mr Jindal was outflanked once or twice by the legislature. In one episode, he misjudged the political climate and had to veto a pay rise for lawmakers he had earlier tried to leave alone.

More serious was his decision to go along with the legislature's plan to reverse a progressive tax plan earlier approved by the voters. The change was pushed during a period of financial ease, as oil money gushed in. When oil prices dropped and the national economy went into decline, Louisiana suddenly found itself staring at a $2 billion hole in the budget. It still is.

Mr Jindal followed a governor, Kathleen Blanco, who was widely seen as ineffective. And with disaster aid still slowly trickling into Louisiana, the state's economy has not been hit as hard as most. Mr Jindal has been lucky, so far.

Baseball

Curveballs

Feb 19th 2009 | NEW YORK
From The Economist print edition

A rough week for New York baseball

Bloomberg News

Say it ain't so

ALEX "A-ROD" RODRIGUEZ is a phenomenal baseball player. He is the youngest person ever to have hit 500 home runs, and is reckoned to have a chance of breaking the all-time record for them, which stands at 762. His ten-year, $275m contract is the most expensive ever signed in the sport. But on February 7th *Sports Illustrated* revealed that he had tested positive for steroids. The test, back in 2003, was conducted by Major League Baseball in a survey designed to judge the extent of performance-enhancing drugs and to see if mandatory drug-testing was needed. It clearly was: more than 100 players tested positive. Mr Rodriguez admitted using "boli", the street name for the steroid Primobolan, between 2001 and 2003. Bud Selig, baseball's commissioner, says the slugger has shamed the game.

In a carefully-scripted press conference on February 17th, Mr Rodriguez, flanked by his Yankee team-mates and manager, offered a *mea culpa*. Blaming youth and stupidity, he claimed, "I didn't think they were steroids," but minutes later admitted "I knew we weren't taking tic tacs". He even outed his cousin as his drug mule. It was not enough: even his fans are now calling him "A-Roid".

Meanwhile across town, the Mets, New York's other baseball team, find themselves immersed in the global financial crisis. Not only is the team's owner, Fred Wilpon, a victim of Bernie Madoff's alleged Ponzi scheme; the team is also in a stew over naming rights. Fans and two congressmen are outraged that Citigroup is paying $400m over 20 years to have the Mets' new stadium called Citi Field. Opponents see this as the worst kind of corporate extravagance. It now seems especially unseemly as Citigroup has been the beneficiary of a $45 billion bail-out and 50,000 Citi employees have lost their jobs. Baseball fans, even Met fans, are angry.

David Carter, of the University of Southern California's Sports Business Institute, reckons that in future, "You will see heightened diligence and sensitivity when crafting naming rights deals." For some, though, it is too late. On February 13th the University of Miami renamed its baseball field Alex Rodriguez Park.

Statewatch: Illinois

Now, to work

Feb 19th 2009 | EAST PEORIA
From The Economist print edition

Barack Obama's home state, racked by scandal, must face its economic woes

AP

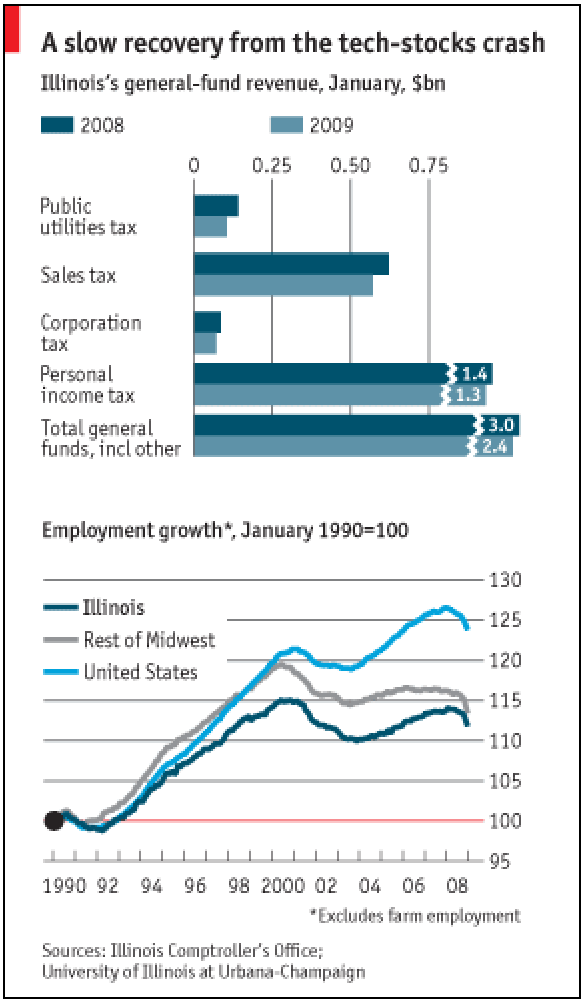
FORTY minutes west of Normal is East Peoria, a suburb of Peoria, the sixth-biggest city in Illinois. Caterpillar, the biggest local employer, announced lay-offs last month. But on February 12th Barack Obama came to East Peoria to tell Caterpillar workers that "here in Illinois" the stimulus would save jobs, provide tax cuts and help the unemployed. It was a rare bit of optimism in a region whose mood is glum.

The president's home state, like many others, is grappling with an ailing economy. But it also suffers its own brand of affliction. For most of December and January Illinois was consumed by the scandal of Rod Blagojevich, the governor who allegedly tried to sell Mr Obama's Senate seat. Now Mr Blagojevich's appointee, Roland Burris, has admitted that he tried to raise money for the governor while seeking the seat, a fact he omitted from testimony in January. A Senate investigation is under way. The distraction is unwelcome.

Illinois entered the recession already weak. The state had never regained the employment levels of November 2000. The government had long been sunk in dysfunction. By May 2008 relations between legislators and the governor in Springfield, the capital, were so frayed that the legislature sent Mr Blagojevich a budget with a projected deficit of $2.1 billion. The governor did not lower spending enough to meet available revenues, explains Dan Hynes, the state's comptroller.

That Illinois is faring better than Michigan, Ohio and Indiana is small comfort. Last year the number of foreclosures there jumped by 55%. Illinois's unemployment rate was 7.6% in December compared with a national average of 7.2%. Matters will probably get worse. During the commodities boom, exports of farm equipment and construction machinery from companies such as Caterpillar and John Deere helped boost the state's economy. That support is now dwindling. Geoffrey Hewings, an economist at the University of Illinois at Urbana-Champaign, explains that Illinois is apt to enter business cycles later than the country, but that its downturns are usually deeper and longer. The state lost 100,700 jobs in 2008, 73,600 in November and December alone.

The recession has affected each part of the state differently. For much of 2008 Peoria and its surroundings remained relatively prosperous. Since the 1980s industries such as health care and business services had expanded. Without any housing bubble to burst, the area's median home price even inched up last year. Nevertheless, Caterpillar looms large, and its job cuts have shaken the region. Of Caterpillar's 22,000 layoffs, at least 1,500 are in greater Peoria. Rick Doty, the president of the local United Auto Workers union, has a Barack Obama commemorative plate on his desk and big hopes for the stimulus. "If Obama's stimulus gets moving with the infrastructure," he contends, demand will rise for Caterpillar's heavy machinery. Mr Obama, during his visit to East Peoria, claimed that the stimulus might spur Caterpillar to rehire workers. Later Caterpillar's chief executive admitted that many cuts would remain.



The recession has had a rather different effect in Chicago. Though souvenir shops still sell election T-shirts, the triumphant mood of November 4th is long gone. The metro area's unemployment rate was 7.3% in December, almost 50% higher than a year earlier. And though Chicago's economy has diversified recently, several industries show symptoms of malaise.

The University of Chicago's hospital is trimming its budget by 7%. Citadel, Chicago's biggest hedge fund, has suspended redemptions on its two biggest funds. Building workers, meanwhile, are hanging up their hard hats. The Chicago Spire, billed humbly as "the most significant residential development in the world", remains a hole in the ground. Construction starts are projected to be worth just $13.7 billion in 2009, about 60% of what they were in 2006, according to a report from McGraw-Hill. City Hall must stretch ever shrinking revenues. A $6 billion budget, passed in November, is already showing a $50m gap.

In Springfield legislators are struggling with a big budget deficit of their own. Mr Hynes, the state's comptroller, estimates the shortfall will increase to $9 billion by next year. Under normal conditions the governor would have presented his budget on February 18th, but the legislators have given Pat Quinn, the new governor, an extra month to devise what he optimistically calls a "rescue plan". His efforts include tapping rescue funds from Washington. It helps that Illinois has a special resonance this year. After Mr Obama spoke in East Peoria, he travelled to Springfield to celebrate the 200th birthday of Abraham Lincoln. Illinoisans can only hope the matter with Mr Burris is resolved soon. There is other work to be done.

Lexington

The end of innocence

Feb 19th 2009
From The Economist print edition

But Barack Obama is winning more than he is losing in the row over the $787 billion stimulus package

Illustration by KAL

BARACK OBAMA is back where he spent the past two years—on the campaign trail. He has been visiting recession-wracked towns, wooing carefully-chosen journalists and drumming up support on the internet. But Mr Obama is also learning that governing is different from campaigning. Selling "hope" and "change" was one thing. Selling a 1,100-page stimulus package that has just emerged from the legislative mill is quite another.

The Republicans have spent the past week arguing that Mr Obama's bill has destroyed any claims that he might have had to be a reformer, partly because the $787 billion bill is stuffed full of boondoggles, but also because of the way that it was sledge-hammered through the legislature. During his long campaign Mr Obama repeatedly promised two things: to reach out to Republicans and Democrats rather than pandering to his supporters, and to let in as much light as possible on the people's business.

But his bill represented the triumph of business as usual, passed with just three Republican votes in the Senate and none in the House, and concocted in secret by the Democratic leadership, a trio of north-eastern Republican senators and a handful of White House aides. Not a single legislator who voted on the mammoth bill can have read it all.

The two devils of partisanship and opacity reinforced each other. Democratic legislators used the power of the gavel and the shield of secrecy to stuff the bill with truffles for their states and, worse, gifts for the interest-groups that pay their bills. The package sends a protectionist signal by including a number of "Buy American" provisions (though these have, admittedly, been watered down). It also sneakily interferes with the financial-services industry, laying down stern limits on pay and making it harder for foreigners to get visas to work there. Incredibly, many of the details emerged only after the bill had been passed.

Mr Obama bears a disproportionate share of the blame for the resurrection of the old politics. True, the politicians on Capitol Hill are guilty of producing the bill's worst excesses. The Democrats treated it as an excuse for partisan advantage, while the Republicans refused to concede that the economy needed a stimulus at all, making give-and-take impossible. But it was Mr Obama who made the fatal error of contracting the writing of the bill to Congress. Mr Obama is surrounded by people, including Joe Biden, his vice-president, and Rahm Emanuel, his chief of staff, who know better than anyone how Congress works. Nancy Pelosi, the speaker of the House of Representatives, is one of the most tribal politicians in

the business—Tom DeLay in a pantsuit. Harry Reid, the majority leader in the Senate, is up for re-election next year and has a popularity rating of less than 50%. Mr Obama might have opted to send a "clean" bill to Congress and to use the economic crisis to force it through without too many additions. Instead, he chose to please his party barons.

Getting it wrong

That is a strike against Mr Obama, to be sure. But he nevertheless seems to be winning the overall game. This is partly because he pushed a stimulus bill through in record time. Most people recognise that, with the country shedding jobs at the rate of 600,000 a month, the "fierce urgency of now" trumps "hope" and "change". But it is also because the Republicans are in danger of overplaying their hand—fixating on railways, golf carts and so on while seeming to ignore the unfolding economic catastrophe.

The Republicans are certainly excited. Conservative talk radio is loud with condemnation of the "porculus" bill. Eric Cantor, the Republicans' ambitious chief whip, has released a pork-mocking YouTube video to the tune of Aerosmith's "Back in the Saddle". He also claims to be studying the tactics of Winston Churchill for inspiration. The recently demoralised Republican caucus is now abuzz with talk of the Gingrich insurgency, when successful Republican opposition to Bill Clinton's agenda prepared the way for the party's seizure of the House and Senate in 1994.

But this strategy is rife with risk. The economic situation is far worse than in the early 1990s. And Mr Obama is a much more powerful president than Mr Clinton was in 1993, with approval ratings in the mid-60s, a big electoral mandate, and something very close to a supermajority in the Senate. Voters may decry the party-line voting on the stimulus bill. But they are also struck by Mr Obama's attempts to court Republicans: in polls 74% say Mr Obama is doing enough to co-operate with Republicans, while 60% say the Republicans are not doing enough to co-operate with Mr Obama. Voters may disapprove of many of the details of the stimulus package. But they also recognise that the economy needs a huge turbocharge to rescue it from free fall.

The Republicans risk opening themselves up to charges of hypocrisy. How can people who voted for budget-busting tax cuts and spending increases during the Bush years now have the nerve to pose as fiscal conservatives? They are also vulnerable to charges of America-be-damned obstructionism. Rush Limbaugh may delight his fans when he says, of Obama, that "I want everything he's doing to fail." But Republican congressmen have to deal with the fact that Mr Obama's failure would plunge the country into disaster.

The Republicans are also paying a direct price for their obstructionism—surrendering what influence they might have had over impending legislation (and playing into Ms Pelosi's hands in the process). The Obama administration is contemplating some of the most far-reaching reforms of health-care and energy policy for decades. But if they continue on their current tack the Republicans risk having no seats at the table and no voice in the debate. Mr Obama may have lost his innocence in the past few weeks. But the Republicans are in danger of losing much more than that if they march to the sound of Mr Limbaugh's drum and declare war on the Obama administration.

Venezuela's term-limits referendum

Chávez for ever?

Feb 19th 2009 | CARACAS
From The Economist print edition

The president has won a referendum to abolish term limits. But the coming economic storm may make this a hollow victory

AP

WHEN Hugo Chávez first proposed abolishing a clause in the constitution he himself had sponsored which limits the president to two consecutive terms Venezuelans rebuffed the idea. That was in a referendum in December 2007. But Mr Chávez, who claims to be leading a socialist revolution, is not a man to take "no" for an answer. Describing the opposition victory as "shit", he vowed to reverse it. On February 15th, after a blitzkrieg campaign involving the brazen use of state resources, the president finally got the answer he wanted. Some 55% of a high turnout of voters said "yes" to a referendum question so convoluted as to be barely intelligible. The constitution will now be amended to permit elected officials at all levels to stand for the same post as often as they like. So Mr Chávez will no longer automatically have to leave office in January 2013, after 14 years in power. But will Venezuelans want to elect him again?

Paradoxically, the opinion polls that accurately forecast the result also showed a slim majority against the indefinite re-election of the president. The explanation is that Mr Chávez once again turned the vote into a plebiscite on himself, says Luis Vicente León of Datanálisis, a leading pollster. Thanks to his rapport with many poorer Venezuelans and to oil-financed social programmes, Mr Chávez remains popular. But Mr León adds that there was "an explicit threat" in the president's message to the electorate: "without Chávez there will be war". In belligerent speeches, he accused his opponents of seeking violence, ordered the police to disperse student demonstrations with tear-gas and said anyone who did not vote for him was guilty of treason. That seemed to apply especially to the more than 3m Venezuelans on the government payroll. On one occasion he held up a list on television and said he would be checking who voted and who did not.

"Yes" propaganda in the streets, on public buildings and on radio and television overwhelmed the opposition's flat and leaderless campaign. But some consolation for the opposition was that for the first time it won over 5m votes. In a presidential election in December 2006 Mr Chávez won by a margin of 25 percentage points. Both the referendum and local elections last November showed that the gap between the two sides in a politically polarised country is now just nine points.

Mr Chávez's support may fall further along with the economy. Unless the oil price rises, Venezuela will earn only $21.6 billion from oil this year, down from $92.9 billion last year, according to VenEconomy, a

business newsletter. Oil is just about the only thing the country now exports. This would represent the sharpest decline in export earnings Venezuela has ever experienced. Oil income accounts for around half of government revenues. The fiscal deficit this year may reach 9% of GDP.

“Crisis? Show me where the crisis is!” Mr Chávez scoffed recently, boasting that Venezuela was well-equipped to weather the storm. He has saved an unspecified amount of past oil revenues and the Central Bank still has reserves of $29 billion (the government snaffled $12 billion from the bank last month). But the bravado is based partly on the hope that the oil price will rise next year, and the conviction that Venezuela’s private banks will be happy to finance this year’s deficit, albeit at a price. They may well do so. According to one banker, the banks have a “gigantic appetite” for government paper because other lending is even more unattractive. The government caps interest rates, but inflation is running at over 30%.

Even so, spending cuts look inevitable. In victory Mr Chávez warned supporters that 2009 would be a year of “consolidation”. Already the wave of nationalisations that began shortly after the last presidential election has come to a halt. The state has dropped plans to buy Banco de Venezuela, a subsidiary of Spain’s Grupo Santander, for $1.2 billion, for example.

Only when things improved in 2010 would the revolution move forward, the president said. But it will survive: if anyone has to suffer, it will not be the poor but “the oligarchy,” he insisted. The government may seek a partial rapprochement, for pragmatic reasons, with private business, but seemingly not with the opposition mayors and governors elected in November, who have faced government harassment. For example, the city hall in Caracas, the capital, has been occupied for weeks by *chavista* squatters backed by armed police sent by the interior ministry. The government calls this a “labour dispute” and says Antonio Ledezma, the new mayor, must sort it out for himself. The opposition hopes to secure a legislative majority at a parliamentary election next year. But Mr Chávez will certainly never go down without a fight.

Political tension in Nicaragua

The new Somoza

Feb 19th 2009 | MANAGUA
From The Economist print edition

Daniel Ortega's slide to autocracy

Illustration by Claudio Munoz

LATER this year Daniel Ortega will celebrate the 30th anniversary of the revolution that toppled the notorious American-backed dictatorship of the Somoza family and brought his left-wing Sandinista movement to power. Though Mr Ortega is once again president, as he was in the 1980s, in other ways Nicaraguan politics have changed radically. Most of his fellow revolutionary leaders have left the Sandinista Party and are now in opposition. And Mr Ortega is well on the way to establishing an autocracy, albeit a bankrupt one, in cahoots with former *somocistas*.

The latest step came last month when the Sandinista-controlled Supreme Court quashed a 20-year sentence for embezzlement against Arnoldo Alemán, a former president (and once an official in the Somoza dictatorship). Several years ago Mr Alemán forged an unacknowledged alliance of convenience with Mr Ortega, which Nicaraguans call "the pact". This wavered when Mr Ortega ignored the opposition's complaints that a pliant electoral authority allowed the Sandinistas to steal municipal elections in November, which independent observers were banned from scrutinising. But hours after Mr Alemán's absolution his Liberal Constitutional Party ended a filibuster in the National Assembly and voted to let the Sandinistas run the legislature's affairs.

The next step, opponents fear, will be to get the assembly to vote for a constitutional reform that would allow Mr Ortega, like his friend Hugo Chávez in Venezuela (see article), to stand for re-election. Or it might involve adopting a semi-parliamentary system in which Mr Alemán would run for president but Mr Ortega would cling to power as prime minister.

The result of November's municipal elections, in which the Sandinistas claimed to have won Managua, the capital, have still not been published. That has not stopped Mr Ortega from holding a floodlit ceremony to acclaim the new mayors. But if Nicaraguans have had to swallow the results, foreigners have not. The United States and the European Union have suspended much of their aid (some $200m between them) pending an electoral review. Since there is no sign of that, "There is a real risk that the [aid] programme will be withdrawn," a European spokesman says.

Until recently Mr Ortega could scoff at these threats, since he enjoyed the largesse of Mr Chávez. But the fall in the oil price means that this is drying up. Nicaragua is one of the poorest countries in the Americas. The budget, already cut by 4% compared with last year, is "unsustainable", according to Bayardo Arce, a Sandinista leader. Capital is fleeing and remittances are falling. Mr Ortega is looking to Russia for support. (Nicaragua is the only country other than Russia to grant diplomatic recognition to South Ossetia, an enclave carved out of Georgia.)

Already unpopular, Mr Ortega seems to have miscalculated in alienating aid donors. Since the municipal election he has deployed gangs of uniformed thugs to break up opposition protests. So far they are armed only with staves, stones and homemade mortars. His regime is starting to resemble the dictatorship he once helped to overthrow. One of the original Sandinista leaders now in opposition says he feels obliged to meet contacts in secret, "as we used to do under Somoza".

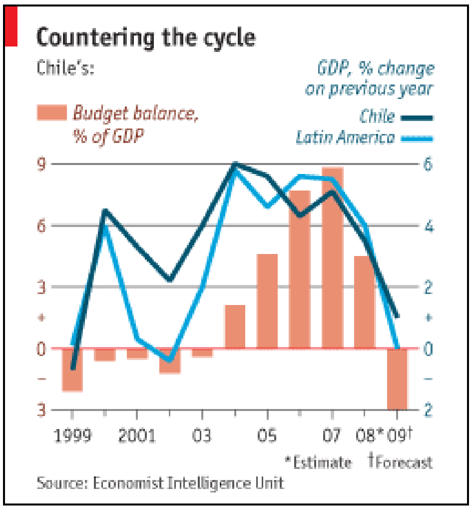
Chile's economy

Stimulating

Feb 19th 2009 | SANTIAGO
From The Economist print edition

Cashing in the fruits of rigour

LONG held up as a model of policymaking that others in Latin America and beyond should follow, Chile's economy has recently seemed oddly lacklustre, with growth below the regional average and inflation stubbornly high. As a small, open economy it is uncomfortably exposed to the world recession—the price of copper, its main export, has fallen by almost two-thirds since mid-2008. But virtue sometimes has its reward. More than any other government in the region, Chile's is able to take action to stimulate the economy. Now it has done so.



Last month Andrés Velasco, the finance minister, unveiled fiscal measures worth $4 billion. Government spending will rise this year by 10.7%. On February 12th the independent Central Bank joined in, slashing its benchmark interest rate by a massive two-and-a-half percentage points, to 4.75%. These measures mean the economy may suffer only a mild downturn.

Mr Velasco's package includes an extra $1 billion for Codelco, the state-owned copper company, to finance investment; $700m for infrastructure projects; extra benefits for poorer Chileans; and temporary tax cuts for small businesses. The measures are better designed than similar efforts in rich countries, says Eduardo Engel, a Chilean economist at Yale University. "There's almost no pork."

Mr Velasco himself says that the challenge is to get the bulldozers moving: "We looked for projects we can do quickly." Much of the money will go on houses for the poor and road maintenance. He reckons these public works will create 70,000 new jobs directly. They follow an earlier, smaller fiscal stimulus last year.

The government forecasts this year's fiscal deficit at 2.9% of GDP, but it can easily afford this. That is because it has stuck to a rigorous fiscal rule drawn up by its predecessor requiring it to save much of the revenue gained when the copper price rises. Not only is public debt minimal (4% of GDP in December), but the government has also piled up $20.3 billion (about 12% of GDP) in a sovereign wealth fund which it can now spend. That marks a contrast with neighbouring Argentina, whose government has financed an increase in spending by nationalising private pension funds, shredding investor confidence.

The fall in commodity prices has at least helped to cut Chile's inflation rate, from 9.9% for the year to October to 7.1% in December. By the end of this year it should have fallen back within the Central Bank's target range of 2-4%, reckons Rodrigo Valdés, the bank's former chief economist who now works for Barclays Capital. He expects further substantial interest rate cuts in the course of the year.

Lower rates will not necessarily encourage Chile's banks, some of which are foreign-owned, to lend. So officials are also trying to inject cash and confidence into the banking system. They have done this in two ways. The Central Bank, which has ample reserves, has auctioned dollars. And the government has given a $500m capital boost to BancoEstado, a state-owned entity which is the third-biggest commercial bank, to allow it to expand lending, especially for mortgages and small businesses.

The government's decision to save so much of the copper windfall was not popular at the time. But "being a Keynesian means being one in both parts of the cycle," Mr Velasco says. His approval ratings in opinion polls have leapt over the past few months, as have those of his boss, Michelle Bachelet, Chile's president. The ruling centre-left Concertación coalition, which has been in power since 1990 and had been looking tired, now has a chance in a presidential election next December it had seemed certain to lose. Good policy can sometimes be good politics.

The restless Caribbean

Unhappy islanders

Feb 19th 2009 | PORT OF SPAIN
From The Economist print edition

Troubles strike far-flung satellites of France and Britain

IT IS a long time since the Caribbean was a European lake, fought over and colonised by rival powers. Yet it still contains a few small fragments of empire—and not always happy ones.

For the past four weeks Guadeloupe, which like its neighbour Martinique is an overseas *département* of France, has been shut down by a general strike. This has turned increasingly nasty. A strike leader was shot dead at a barricade on February 17th, and emergency workers and police trying to help him came under fire, according to the local prefect. Some businesses were looted and cars burned. The strike has spread to Martinique. Thousands of tourists have cancelled holidays.

The strikers want a €200 ($251) increase in the monthly minimum wage. After remaining aloof, France's president, Nicolas Sarkozy, ordered a review of French policy towards its Caribbean territories. The government sent 260 gendarmes and said it would offer a wage increase.

Legally, Guadeloupe is as French as the Gironde. Culturally, Gallic influence is mixed with Afro-Caribbean. Fly in from former British colonies like Dominica or St Lucia and Guadeloupe looks a model of prosperity and, normally, good order. Schools, hospitals and salaries meet French standards. But prices are up to 30% higher than in France, says a businessman in Martinique. Even milk, cheese and lettuce are freighted across the Atlantic. Unemployment stands at 22%.

Behind economic grievances lurks racial tension. Local white businessmen are blamed for high prices. Civil servants from the mainland are resented. Plenty of Guadeloupeans (who number around 460,000) loathe the French but love the subsidies from Paris. There were bomb plots in the 1980s and riots in 2001, but few islanders vote for independence.

Where the French burn barricades, residents in Britain's remaining Caribbean colonies, such as the Turks and Caicos Islands, call for royal commissions. The islands' elected premier, Michael Misick, pays himself more than Gordon Brown for running a territory of 36,000 people. When members of the foreign-affairs committee of Britain's House of Commons visited last year, they were met with fury about Mr Misick's alleged misdeeds.

Sir Robin Auld, a former judge of Britain's court of appeal appointed to investigate the complaints, has heard evidence of extravagant public spending on the premier's estranged wife, LisaRaye McCoy, an American actress; monthly payments of $165,000 for a private government jet; and claims of suspect land deals. Mr Misick denies any wrongdoing; he has said he will resign, but not until late March. He may have to go when Sir Robin reports at the end of this month.

Most of Britain's former colonies in the area won independence in the 1960s. Six territories, including the Turks and Caicos Islands, were held to be too small or too poor to go it alone. Some, such as Bermuda, have since prospered from finance and tourism. But all have been plagued by an uneasy relationship between a British-appointed governor and local political leaders, and periodic scandal. There is occasional talk of independence. But as in Guadeloupe, few voters have wanted to make the break.

Mexico's ceramics industry

A clean plate

Feb 19th 2009 | MEXICO CITY
From The Economist print edition

A battle for lead-free pottery

UNTIL recently, the glaze on most Mexican pottery contained lead. This was practical: lead fuses into a shiny glaze at less than 800° Celsius, the most that artisan kilns achieve, whereas the alternatives required more than twice the heat. But it was a problem for Mexican potters, of whom the government reckons there are between 2m and 4m. They suffered from lead poisoning, and to a lesser degree so did customers who bought their plates and cups. Their products were banned from the American market, where their hand-painted beauty could fetch much higher prices than in rural Mexico, where the pots were merely a practicality.

Over the past 15 years the lead has gradually disappeared, thanks to the efforts of Fonart, a government entity that promotes handicrafts, and various NGOs. Researchers sponsored by them came up with a non-toxic, low-temperature glaze based on boron. They also encouraged potters to install fans costing just $40 in their kilns so that combustion became more efficient. Thanks to these changes, some Mexican potters who used to make less than $1,000 a year are now earning up to $40,000 by exporting to the United States and Europe, says Eric O'Leary, an American potter who has worked with Fonart.

Some villages are now nearly lead-free. But although the new boron-based glaze now costs only a third as much as the traditional lead-based mix, getting people to change a centuries-old tradition is not easy, says Eduardo Berrocal of Fonart. In all, only around half the potters have switched. But the first half is the hardest.

American diplomacy in Asia

Hillary says hello to Asia

Feb 19th 2009 | TOKYO
From The Economist print edition

A well-received first trip abroad as secretary of state, listening not lecturing

AFP

UNTIL this week only one American secretary of state had made his first foreign trip to Asia: Dean Rusk, in 1961. So Hillary Clinton's decision to start her travels with a tour to Tokyo, Jakarta, Beijing and Seoul surprised even her hosts. The message seems to be that war elsewhere and economic turmoil may be the current preoccupations, but America's future environment will be shaped in Asia.

Besides, it is always good to go where you are welcome. It is not simply that President Barack Obama's four childhood years in Indonesia make him a hero there; nor that learners of English have cleaned out the Tokyo bookshops of volumes of his speeches. Rather, despite the damage George Bush did to America's prestige, in East Asia it remains high.

According to a recent survey of Japan, South Korea, Indonesia, China and Vietnam by the Chicago Council on Global Affairs, America's "soft" power—ie, its ability to influence others through attraction rather than coercion—has actually grown. Everywhere, America ranked ahead of China in terms of soft power, measured as a mix of political, economic and cultural appeal. It ranked first in Japan, South Korea and China. In Indonesia and Vietnam it took second place, to Japan. That China limped in third overall clearly came as a surprise to the Chicago Council, which had roped in a noted China hand, David Shambaugh, to write up the findings.

Yet East Asia was somewhat neglected under Mr Bush, especially in the second term. The cause was partly bureaucratic. After it was launched in 2006, the "strategic economic dialogue" with China came to dominate the bilateral relationship at the expense of broader issues such as security and human rights. At times, it seemed relations were the sole preserve of the former treasury secretary, Hank Paulson.

As for the State Department, its East Asia agenda was consumed by North Korea, which exploded a nuclear device in October 2006. Mr Bush's assistant secretary of state for the region, Christopher Hill (who accompanied Mrs Clinton), focused on little else. This irked Japan. Not only did the United States appear to be neglecting its biggest Asian ally. Japanese and South Korean warnings against over-hasty deals with North Korea were also ignored.

America took the North off its blacklist of state sponsors of terror last autumn, in return for an oral promise about verification procedures for disabling facilities at its nuclear reactor. The North has since all

but disowned the promise at the six-party talks aimed at getting it to disarm. Meanwhile, progress on tackling suspected uranium enrichment, nuclear proliferation and the North's existing handful of plutonium weapons remains as elusive as ever.

Now North Korea has grown shrill towards South Korea, which under President Lee Myung-bak does not want to give unconditional aid. The North may try to provoke a naval skirmish. Preparations for a long-range missile test appear under way, and another nuclear test cannot be ruled out. North Korea may yet dominate America's East Asia policy and attempt to drive wedges between America and its friends, as it did under Mr Bush.

In Japan Mrs Clinton had to mend a fence she broke herself. Laying out her stall in *Foreign Affairs*, a wonkish journal, in late 2007, she almost forgot Japan in her stress on China. There is no surer way to feed Japanese insecurities. Yet in Tokyo she hailed the security alliance with Japan as a cornerstone of American foreign policy. And she invited the prime minister, Taro Aso, to be the first foreign leader to meet Mr Obama, on February 24th (assuming he clings to office that long). Any new bonhomie, however, will be tested when America asks a foot-dragging Japan for more help abroad—for instance, by flying supplies into Afghanistan, now that overland routes from Pakistan are repeatedly subject to Taliban attacks.

Mrs Clinton is visiting Indonesia partly as a proxy for re-engaging with South-East Asia as a whole: the region badly wants continued American engagement as a counterbalance to China's growing military might. But Indonesia also matters as a huge Muslim nation, where, as the foreign minister, Hassan Wirajuda, put it, "Islam and modernity can go hand-in-hand."

China, for its part, wants reassurance that not much will change, at a time of rising protectionist pressure in America. It was relieved not to have been demonised during the presidential campaign, and Mrs Clinton's talk of wishing it to be committed to international norms echoes the language of the Bush administration. *China Daily*, an official newspaper, has even expressed the hope that military exchanges, suspended last year over American arms sales to Taiwan, might be resumed. But Mrs Clinton's suggestion that dialogue has been too centred on the economic at the expense of the strategic gives Chinese policymakers the jitters.

In general, Mrs Clinton has appeared to be listening more than speaking. Still, it is possible that the biggest change in America's Asian diplomacy will be to put global warming near the heart of it. On the trip Mrs Clinton brought her special envoy on climate change, Todd Stern. China, the United States and Indonesia (because of deforestation) are the world's biggest emitters of greenhouse gases. Japan has perhaps the best clean technology. China has yet to show any readiness to make specific commitments to cut carbon emissions. But if offered technological and other bribes, it might prefer not to be seen as an obstacle to the global agreement on carbon reductions hoped for late 2009. That would be a coup for Mrs Clinton's Asian diplomacy, though a distant goal for now.

Japan's crashing economy

Cold medicine

Feb 19th 2009 | TOKYO
From The Economist print edition

Both politics and the economy flounder

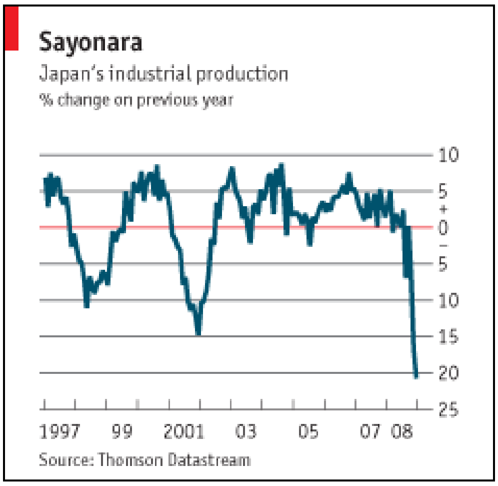
INCOHERENT, floundering, sleepy and confused. The demeanour of Japan's finance minister, Shoichi Nakagawa, at a G7 press conference in Rome on February 14th typified the country's economy and politics. Mr Nakagawa, forced to resign a few days later, blamed his apparent drunkenness on "cold medicine". But there is no ready remedy for what ails Japan.

The Japanese economy contracted 3.3% in the final quarter of 2008, the third consecutive fall, mostly due to a collapse in overseas demand compounded by a strong yen. Economists forecast a drop of around 4% in 2009—a contraction twice as severe as in America and Europe.

"We are facing the biggest economic crisis since the second world war," said Kaoru Yosano, the economics minister, who added the finance ministry to his business card after Mr Nakagawa's departure. Corporate profits have collapsed—down 89% on last year. Big manufacturers' output is down by 20-40%. Toyota has halved its output. Bellwether companies from NEC to Nissan have slashed jobs and investment. Industrial output is expected to fall to levels not seen since the 1980s (see chart).

The government's handling of the economy has resembled Mr Nakagawa's slurred performance. Of the ¥12.6 trillion (around $150 billion) in stimulus packages the ruling Liberal Democratic Party (LDP) has put forward, only a quarter has been implemented. The delay arises from political deadlock. Part of the hold-up is caused by a plan for ¥2 trillion in cash handouts to individuals, which has little public support and is rejected by the main opposition, the Democratic Party of Japan (DPJ).

The prime minister, Taro Aso, Mr Yosano and the LDP's leadership have in private agreed on an even bigger package, of as much as ¥30 trillion, which they plan to unveil after the 2009 budget passes the Diet (parliament). It looks more hopeful than previous efforts. Some investment, such as building a new runway and terminal at Haneda, the airport closest to Tokyo, to make it a proper international one, will raise productive growth. But after the tortuous budget deliberations and the difficulty of passing earlier, smaller stimulus proposals, the chances that one planned on the quiet might pass are remote.



The biggest threat to the economy is neither business nor finance. It is politics. Mr Aso's reputation has been shredded by a series of gaffes and policy flip-flops. The latest occurred this month when he declared that as a minister he opposed the privatisation of Japan Post, the hallmark policy of Junichiro Koizumi's premiership in 2001-06. Mr Koizumi, who plans to leave politics but remains highly popular, derided Mr Aso's view as "laughable", weakening Mr Aso's support in his party.

Mr Aso also, blind to the public outcry, at first gave Mr Nakagawa his full support. For all his alleged tippling, Mr Nakagawa was one of the bright sparks in the cabinet and someone Mr Aso came to rely on. The LDP has been in power for all but 11 months since 1955, but Mr Aso governs with approval ratings that some polls place at less than 10%. The DPJ is expected to trounce the LDP at the general election Mr Aso must call by September. But the DPJ has even less of a clue about how to tackle the economic mess. It will toast victory with cold medicine, but inherit a hangover.

China's rural consumers

Pretend you're a Westerner

Feb 19th 2009 | BEIJING
From The Economist print edition

Buy something you can't afford

THOSE living in the countryside have been hit hardest by China's economic slowdown. Yet the media show pictures of gleeful farmers buying televisions and fridges. Since February 1st all China's more than 200m rural households have been eligible for a government-financed discount on such purchases. From next month they will be entitled to subsidised cars as well. Unfortunately, glee is very confined.

The government has expressed great hopes for rural spenders as a new engine of economic growth. Hence the subsidy scheme: get peasants to spend, goes the official thinking, and the country's ailing export industries will find a vast new market. The idea was to reduce the household-appliance industry's bloated capacity and reliance on exports for half its sales. It was also a way to help manufacturers as the yuan appreciated. In 2007 an experiment was launched in three provinces. Rural households could enjoy a 13% discount on a number of items from each category of goods on a list of designated models.

The experiment was due to end last year. But as China's exports plunged, officials decided to extend it, first to another nine provinces in December and then, this month, nationwide (with added product categories, including motorcycles and computers in some places). It is to run for four years. Its impact so far is hard to assess from patchy official figures. In the first three provinces, the volume of rural sales of household appliances of all kinds in the 11 months ending October 2008 was 40% higher than in the same period a year earlier. But the *Economic Observer*, a Beijing newspaper, said the sales value of designated products was only 40% of the government's target. Yan Shengqin of Beihe village, in Shandong province, says the distance to the sole officially approved retail outlet and the limited product range deter him and his neighbours.

The scheme has many sceptics. Officials now estimate that some 20m migrant workers from the countryside have recently lost their jobs. Their remittances to relatives in the countryside had been a big driver of rural spending. So Hu Biliang of the Chinese Academy of Social Sciences says it would be "good news" if rural incomes, which include earnings by migrant workers, were to grow at all this year. Better, he says, to put more government money into infrastructure and health care, where recent spending increases are still far from enough.

Even some official newspapers have published complaints about the fairness of the scheme (why should poor urban residents not enjoy the same discounts?) and its impact on free competition in the market. The products of many more companies, including a handful of foreign ones, have been added to the lists. But some have suggested it might be fairer and less bureaucratic to give coupons to rural residents to spend as they want, as has been tried in Taiwan. At present, to get their discounts, claimants need to take proof of purchase and residency to a government office. The money may then take 15 working days to reach their accounts.

The government still has high hopes. Fu Ziying, a deputy minister of commerce, claimed in the press that the policy could boost rural sales of consumer goods by 2.5%. "Active consumption is patriotic and being patriotic involves loving oneself," argued an essay in *Liaowang*, an official journal. But China's out-of-work peasants may not be ready to pamper themselves.

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Cambodia's Khmers Rouges on trial

Evil and the law

Feb 19th 2009 | PHNOM PENH
From The Economist print edition

Thirty years after he was put out of business, a torturer gets his day in court

AFP

Tuol Sleng, tourist attraction

JUSTICE moves slowly in Cambodia, even—or perhaps especially—where genocide is concerned. Thirty years after a Vietnamese invasion toppled the Khmers Rouges, and nearly ten years after he was detained, Kaing Guek Eav, known as Duch, this week became the first leader to face trial at a UN–backed "hybrid" tribunal on the dusty outskirts of Phnom Penh, set up to achieve justice for survivors of a regime that killed perhaps 2m people.

Duch ran Tuol Sleng or S-21, a notorious Phnom Penh prison (now museum), where more than 14,000 men, women and children were tortured and killed. For two days of procedural hearings the 66-year-old Christian convert sat attentively. At each adjournment he stood, touched his clasped hands to his forehead, and bowed to the crowded court. "Now he is just an old man. Before, he was the absolute man," says Vann Nath, who survived S-21 because Duch let him paint a portrait of the Khmers Rouges' leader, Pol Pot. "Whether someone lived or died hinged on him."

Duch is being tried separately from four other detainees, all, unlike him, central-committee members. His systematic interrogations in S-21 left a damning trail of evidence, and he is vital to the effort to understand the regime. "He alone has admitted his deeds and will almost certainly point the finger to implicate others," says Alex Hinton, of Rutgers University's Centre for the Study of Genocide and Human Rights.

This week lawyers proposed witnesses and noted arguments. François Roux, the defence lawyer, from France, was expected to condemn Duch's prolonged detention, and Robert Petit, the main international prosecutor, to claim that Duch was part of a joint criminal enterprise—an attempt to implicate the other defendants in the S-21 atrocities. The court also debated whether a child survivor of S-21 could register as a victim despite missing the deadline, or if a husband could represent his dead spouse.

The success of the court remains in doubt. Elderly victims and the defendants themselves (the others are over 75) may thwart it by dying. It took ten years of talks between Cambodia and the UN before the court opened in July 2007. In March the court's Cambodian side will run out of money. In December the international prosecutor publicly disagreed with his Cambodian co-counsel's refusal to seek other defendants. This raised questions about political interference. Cambodia's prime minister, Hun Sen, among others, is a former Khmer Rouge cadre.

Yet Duch seems likely to get the trial he and his victims seek. Mr Petit requested 40 days for questioning his witnesses. The defence witnesses include Duch himself, who, according to his lawyer, intends to apologise to victims and answer their long-held questions about the torture prison. Mr Roux worries that

no amount of candour by Duch could fully explain the horrors of S-21: “I’m not sure that a human being can explain something inhuman.”

Sri Lanka's Tamil Tigers

The Tigers' lair

Feb 19th 2009 | COLOMBO
From The Economist print edition

Not your usual bunch of thugs

AS THE Sri Lankan army drives the Tamil Tigers from ever more of the northern territory they once held, a fuller picture is emerging of the rebels. Soldiers have stumbled upon weaponry that speaks of a well-resourced militant group that had systematically armed itself to bomb a government into submission. Hiran Halangode, a retired brigadier, describes them as a well-financed, innovative group: "not the run-of-the-mill sort of organisation with an ammo dump that you could catch any time you wished".

Since the army started converging on the district of Mullaitivu in January, it has found training facilities for suicide-bombers and other fighters and factories producing chemical bombs. At Dharmapuram, soldiers located underwater fuel-storage tanks with 67,500 litres of diesel. Inside thick jungle, hidden from aerial view, they hit upon boatyards and completed submarines. The defence ministry's website later called the Tigers "the first terrorist organisation to develop underwater weapons". Among the other boats were fast-attack craft and some built for naval suicide-missions.

According to the army, whose reports cannot be verified, it has also found improvised mortar launchers, ammunition dumps, sophisticated transmission equipment, armour-plated vehicles and heavy machinery used to dig deep "moats" around Tiger bases. Scattered around Mullaitivu and Kilinochchi districts, the army found two aircraft hangars, seven airstrips, and a training facility for the rebels' rudimentary "air wing". But the three light-wing aircraft the Tigers used in eight attacks on military facilities are missing. An air-force spokesman says they "probably went back into the boxes they had come in".

Perhaps most interest has been drawn by several multi-storeyed, underground shelters that the army suspects were used by Velupillai Prabhakaran, the Tigers' heavily protected (and diabetic) leader. At ground level, the bunkers look like ordinary houses. Below, they have bulletproof doors and impermeable concrete walls one-metre (three-foot) thick. They are furnished, often tiled and were air-conditioned with electricity from soundproof generators. A 50-foot-deep shelter at Mullaitivu was fitted with a lift to the surface. On a bedside table was a container with empty vials of insulin.

Zimbabwe

Not yet unity

Feb 19th 2009 | HARARE
From The Economist print edition

Will Morgan Tsvangirai wield real power? Not yet, it seems

AFP

THE new unity government of Zimbabwe, launched with fanfare on February 13th, has got off to an inauspicious start. It appears that orders issued by the new prime minister, Morgan Tsvangirai, leader of the Movement for Democratic Change, are already being countermanded by ZANU-PF, formerly the sole ruling party, still bent on keeping the upper hand. Rumours of a coup, planned by a cabal of disgruntled senior security men and ZANU-PF bigwigs opposed to any real power-sharing, are rife. No one knows quite who is in charge.

There are even whispers—wishful thinking, perhaps—that President Robert Mugabe may be tempted to use his traditional birthday address to the nation on February 21st, when he turns 85, to announce his resignation after ruling his once-prosperous country with an increasingly despotic hand since 1980. Some think he is physically flagging and that his mind has begun to wander. But others say he is in full possession of his faculties and determined to stay in office until he dies.

Things started to go wrong on the day a new 31-minister cabinet was sworn in by Mr Mugabe before an array of African dignitaries, including Kgalema Motlanthe, South Africa's president, who currently chairs the Southern African Development Community (SADC). It was that 15-country club that clinched the power-sharing deal, ten months after Mr Tsvangirai had won the parliamentary election and the first round of the presidential poll.

First, Mr Mugabe turned up with 22 ministers, whereas the agreement generously gave him 15 cabinet posts to the MDC's 13, with a small opposition group led by Arthur Mutambara getting three. After hours of argument, Mr Mugabe agreed to withdraw six of his names.

Then, while the swearing-in ceremony was under way, security forces detained one of Mr Tsvangirai's ministerial nominees, Roy Bennett, as he was about to fly off to spend the weekend with his family in South Africa, where he has been living in exile for the past three years. After being bundled into a car said to belong to one of Mr Mugabe's ministers, he was driven to Mutare, 210km (130 miles) from

Harare, the capital, where he was jailed and charged with treason. An embarrassed Mr Motlanthe protested, only to be assured that the detention of one of the MDC's most prominent politicians, who had been due to be sworn in as the deputy agriculture minister, had taken place without his host's knowledge and that orders had been given for his release.

As *The Economist* went to press, Mr Bennett was still in prison, though the treason charge had been replaced by ones of insurgency, banditry, sabotage and terrorism. Some 40 other political detainees, among them Jestina Mukoko, a leading human-rights campaigner, are also still being held, though Mr Tsvangirai had made their release a condition for signing the deal that many in his party had strongly opposed.

It was also opposed by many of ZANU-PF's old guard, loth to share the spoils of power. Suspicions of a plot to sabotage the new government were heightened by the conspicuous absence of the leaders of all the security forces at the swearing-in ceremony. Equally notable was the failure of Mr Mugabe, their commander-in-chief, to comment on their snub.

Reports began to circulate that a cabal of leaders of the army, the police, the prisons and intelligence services had been holding daily meetings at a farm near Harare, where arms were said to be cached. Other ZANU-PF figures were cited as the brains behind the plot. "War veterans", the groups responsible for seizing white farms, were also said to be involved.

Theories abound. Is Mr Mugabe behind these alleged plots or does he just quietly endorse them? Has he lost control of his armed forces? Some say that elements of them have been acting off their own bat, without the president's explicit approval, for the past year. "Mugabe may still be on the bridge, but he's by no means in command," says a Western diplomat, stating a view held by many of his colleagues. But others think the president still holds plenty of power. "Even those who dislike him are still in awe of him," says a local commentator. "Don't count him out yet."

Even if Mr Mugabe's senior security men wanted to launch a coup, it is uncertain that the rank and file would obey them. Mr Tsvangirai has sought to secure their loyalty by promising that civil servants, many of whom have been on strike for months, would be paid in foreign currency instead of worthless Zimbabwean dollars. But it is unclear where he will find the cash.

At a meeting of Zimbabwe's main foreign donors this week, Mr Tsvangirai asked for help in footing the bill, estimated at $50m a month, for the first six months. So far, especially after the unity government's shaky start, most are reluctant to oblige. Britain and the United States, Zimbabwe's two biggest donors, are unlikely to resume development aid—as distinct from humanitarian aid, which they are pumping in at record levels—as long as Mr Mugabe remains in power as president.

So far Mr Tsvangirai has kept his head down. Despite the many attempts of Mr Mugabe's old guard to humiliate and undermine him, he has made no public complaint. That, he believes, would alienate those in ZANU-PF whom he hopes to win over. Echoing Nelson Mandela, he says the road to freedom will be long. After this week, few would disagree.

Saudi Arabia

Tiptoeing towards reform

Feb 19th 2009
From The Economist print edition

The king makes some striking changes, but gradualism is still the watchword

AP

King Abdullah sends a Valentine

REFORM-MINDED Saudis cheered when Abdullah became king four years ago. The avuncular Custodian of the Holy Places, as Saudi monarchs title themselves, had a reputation for probity, tolerance and humility that augured change for the better. Yet few of his tentative reforms have stuck. Initiatives to modernise state schools and courts have stalled in the face of entrenched religious conservatives.

But in a move of rare boldness for the stately kingdom, on February 14th the 86-year-old king decreed sweeping changes in government. His reshuffle affected top posts in education, the courts, the armed forces, the central bank, the health and information ministries, the religious police and the state-appointed religious hierarchy, as well as the royally-appointed, 150-man proto-parliament, the Shura Council.

It was not the scale of the turnover that raised eyebrows; most senior ministers retained their posts. More striking was the injection of reformist blood into the ossified school and court systems. With his background in intelligence, and as a son-in-law of the king, the new minister of education, Prince Faisal bin Abdullah bin Muhammad, may be better equipped to flush out teachers who are failing to comply with curricula that have been revised to emphasise tolerance in Islam.

The departure of Sheikh Saleh Luhaydan as head of the supreme judicial council, along with several other senior judges, suggests a new push to modernise the courts. Mr Luhaydan was notorious for rulings such as one that said it would be legal to kill the owners of TV channels broadcasting "immorality". During his tenure judges faced little pressure to adopt new rules meant to make the kingdom's unique and often harsh forms of *sharia* justice more open and consistent. Similarly, the sacking of the head of the Commission for the Promotion of Virtue and Prevention of Vice will be seen as a response to a chorus of demands to curb the morality police, whose puritanical agents have often been accused of harassing law-abiding citizens.

Equally significant, the new appointments are markedly diverse. The 21-man board of senior clerics which issues official religious rulings, or *fatwas*, now for the first time includes representatives of all four schools of Sunni Islam, so breaking the monopoly, exercised solely in Saudi Arabia, of the arch-traditionalist Hanbali school associated with Wahhabism. The body still excludes Shias, a minority numbering about 10% of Saudis that faces widespread discrimination. But King Abdullah has compensated in part by increasing Shia representation in the Shura Council.

A far bigger slice of the population that has been kept to the margins of society, namely women, also got a boost with the appointment of a female deputy minister, the highest-level government post yet to be filled by a woman. Nora al-Fayez, an American-educated schools administrator, is to run the girls' section of the ministry of education, a division managed until recently by Wahhabist clerics.

Should such personnel changes give an impetus to the deeper reforms that many Saudis long for, King Abdullah will have secured an important legacy. But a quite different reform, decreed by him three years ago, may bear fruit sooner. Addressing concerns that the line of succession to kingship, which traditionally passes between brothers before reaching their sons, would produce a series of brief reigns by dotards, King Abdullah created a 25-man family council to elect future kings.

The council was to meet only after his own brother had succeeded. But the current crown prince, Sultan,

is in his 80s and said to be very ill. In all likelihood, it is the council that will choose Abdullah's successor, in what might prove to be, even if restricted to a handful of senior princes from the Al Saud family, the first quasi-democratic transition of power in Saudi history. It would be a momentous feat. But it will also set nerves jangling.

Israel and the Golan Heights

A would-be happy link with Syria

Feb 19th 2009 | MAJDAL SHAMS
From The Economist print edition

The Druze of the Israeli-occupied Golan Heights can help both Israel and Syria

AP

PERCHED between Israel, their occupier for more than four decades, and Syria, perhaps soon to govern them again, the 20,000 Druze of the Golan naturally seek out interests that are common to their two powerful patrons as a way of improving their own precarious situation. By the by, they even hope to serve as a peace-building bridge between the two. Some optimists see the future Golan as a sort of Hong Kong, continuing to enjoy the perks of Israel's dynamic economy and open society, while coming back under the sovereignty of a stricter, less developed Syria. Whoever becomes prime minister of Israel after its recent general election will be likely to open a diplomatic "track" to Syria. Barack Obama has also sounded keen.

As a hoped-for harbinger of co-operation, the Druze manage to send their apples to the markets in Damascus, Syria's capital, with the blessing of the Israeli government, which even provides an Israeli export subsidy for every tonne sent. The local growers' co-operatives have been authorised to send 8,000 tonnes this year, the biggest consignment since Israel's then prime minister, Ariel Sharon, first agreed in 2004 to allow this trade with Syria.

Though not exactly a humanitarian cargo, the apples are shipped in Red Cross lorries through the UN-patrolled border at Kuneitra. The first three loads crossed into Syria this week. Their main importance is more diplomatic than economic. For Syria, they show sovereignty over the occupied region and solidarity with its people, who have kept faith with the Arab motherland despite Israel's efforts to woo them. For Israel, they offer a first glimmer of the open borders and free trade which, it insists, must be part of a future peace treaty.

For the Druze growers themselves, says Assad Safdie, who manages a state-of-the-art cold-storage fruit warehouse on the Golan, exporting to Syria helps them compete against local Jewish settlers, who also grow apples and get more generous water allocations from Israel's government. "They get twice as many apples per dunam," he says, "but ours are twice as tasty."

Beyond the price the apples fetch ($6m last year, passed back in cash) and the political capital both countries make out of them, the Golan Druze, with almost every family owning an orchard, say they and their apples have a part to play in a gradual, mutual de-demonisation that goes with peacemaking. They hope that talks between Israeli and Syrian officials under Turkish mediation will soon resume.

The Druze are an ancient sect within Islam. The Golan ones are part of a Syrian Druze community that numbers 700,000. Another 250,000 live in Lebanon and about 100,000 in Israel proper, where, unlike other Muslim and Christian Arabs, they serve in the army.

The Red Cross ferries across the border hundreds of young Golan Druze who study in Damascus, encouraged and paid for by Syria's government. Almost all go home once qualified, many to jobs in Israel itself. Hundreds more graduate from Israeli universities. Druze families used to call and wave sadly across the border to each other at a "shouting hill", just outside Majdal Shams, a modest town on the north-east edge of the Golan Heights. Now they direct-dial or Skype. They still cannot cross the border to meet but they can and do hop over to Jordan for

frequent reunions.

“This openness is good,” says Selim Brake, who has moved from Majdal Shams to the Israeli town of Karmiel and teaches Israeli politics at the University of Haifa. “It reduces tensions. It helps Israel’s image in Syria. Demonisation is *passé*. Both countries have a compelling interest in peace. I believe in our community’s role as a link. The apples could be a pilot for economic projects in the future.”

Maray Taiseer, a fiercely pro-Syrian nationalist who runs a medical and cultural centre in Majdal Shams, says much the same. “We know Syria’s not perfect. But Israel’s propaganda blackens Syria much more than is true. On the other hand some Syrians find it hard to grasp the complexities of Israeli society.” He recalls frank conversations with his own brother, a retired Syrian army officer. “Yes, we’ll have problems after Syria’s return,” he says.

Most Golan Druze, well educated and relatively prosperous, are comfortable in Israel’s free-wheeling society. Mr Taiseer has a doctorate from the Hebrew University of Jerusalem and considers himself, despite his reservations about Zionism, a disciple of Professor Yeshayahu Leibowitz, a famous doveish-Zionist scientist and philosopher. “We will have to adjust. But our roots are very deep and strong. And the Syrians will be sensible enough to take account of our experience.”

Mr Taiseer expects a bonanza of foreign investment in the Golan once a peace deal is struck. The Druze, he says, will be in the forefront. “I don’t think I’m being too Utopian. Golan Druze were always very involved in Syrian political life. And very accepted. The Mossad [Israel’s intelligence service] never understood this.”

Dr Brake says not everyone in the community is so keen. “People calculate: there’s no reason not to sound pro-Syrian. In Israel you lose nothing. If the Syrians do return, it’ll be notched up to your credit.”

Iraq and its Kurds

Not so happy

Feb 19th 2009 | ERBIL
From The Economist print edition

The new strength of Iraq's central government is alarming the Kurds

IN ITS campaign to attract foreign investment, Iraq's self-ruling Kurdish region often promotes itself as the "gateway to Iraq". If investors set up shop in the country's most stable area, they will, say the Kurds, be guaranteed pole position when the rest of Iraq becomes safe for business. Hitherto, visas issued at the Kurds' two international airports or at their land crossings with Turkey and Iran were accepted by Iraq's central authorities when visitors travelled on to Baghdad and beyond. Thousands of foreign businessmen and journalists used to take advantage of this easy entry into Iraq. But Iraq's prime minister, Nuri al-Maliki, recently declared that foreigners entering via the Kurdish region without a visa issued by the central authorities may be arrested and deported. So the "gateway" has, for the moment, been closed. Mr Maliki presumably intends to show the Kurdistan Regional Government who is ultimately in charge.

In the past year or so, Iraq's Kurds, despite the enviable security of their territory, have been on the back foot in Iraqi politics. As violence in the rest of the country has subsided, territorial disputes between Kurds and Arabs—in the province of Kirkuk and in parts of Nineveh and Diyala—have become more dangerous again. And the Kurds are increasingly angered by their continuing failure to seal an agreement with the central government on an oil law.

The Kurds still want a referendum to decide whether Kirkuk and other Kurdish-populated areas, as well as those "Arabised" under Saddam Hussein, should become part of their self-governing region. According to the constitution, this referendum should have been held by the end of 2007, but it has been postponed repeatedly and some Arabs now argue that the constitutional requirement has lapsed. The Kurds also demand the right to manage the extraction and exploration of oil in their region, although they say they would continue to share the revenue equally with the rest of Iraq.

In local elections held at the end of last month in 14 of Iraq's 18 provinces (but not in the three Kurdish ones or Kirkuk), Kurdish parties lost ground in the mixed provinces of Nineveh and Diyala to Sunni Arab parties, which had previously boycotted the polls. Tension between Arabs and Kurds, especially in those areas, has risen. In Nineveh, a stridently anti-Kurdish group called al-Hadba (an Arabic name for Mosul, the capital), led by Sunni Arabs, won the council with 49% of the votes. The Kurds had previously run the show there, thanks largely to the Arab boycott.

Many Kurds now worry that a strongman may once again be emerging in Baghdad. The Kurdish parliament's deputy speaker was reported to have called Mr Maliki "a second Saddam". With American approval, the prime minister has consolidated his power. His Islamist Shia party did well in the local elections on a relatively secular law-and-order platform. He called for strong central government, anathema to the Kurds after their suffering at the hands of Saddam. Arab politicians, seemingly with tacit American approval, have begun to deride the Kurds more openly for their supposed "stubbornness". Mr Maliki and Masoud Barzani, president of the Kurdistan region, get on badly and have not met for months.

Mr Maliki has questioned the Kurds' right to control some of the disputed areas, for instance around the town of Khanaqin and in some parts of Kirkuk province. He has even deployed Iraqi troops there to test the Kurds' response; the Kurds have so far refused to be provoked into fighting. He has also promoted constitutional changes to dilute the power of regions.

The Kurds' political standing has been further weakened by strife within the Patriotic Union of Kurdistan (PUK), one of the Kurds' two main parties, which is headed by Iraq's president, Jalal Talabani. Five senior PUK men resigned, calling Mr Talabani too autocratic, but then came back into the fold when he said he would try to meet some of their demands. Alarmed by this apparent dip in the Kurds' political fortunes, Nechirvan Barzani, the Kurdish region's prime minister (and nephew of its president), has raised the spectre of war with Iraq's Arabs and called on the Americans to settle the main unresolved issues before their troops withdraw from the country.

So far, however, the Kurds' love affair with the Americans has seemed one-sided. "We love them but they don't care," the Kurdish region's prime minister said recently, not for the first time. "When we say something about protecting our people's rights, they see it as a problem that disrupts their Iraq policy." Some Western diplomats, afraid that Kurdish-Arab tension may boil over again, think the Americans should do more to get the UN and perhaps the European Union involved in broking a deal. The Kurds want President Obama to appoint a special envoy to tackle the issue, but he shows no sign of doing so. The new administration, says one American general, would probably still want to "kick the issue down the road".

Iraq's Kurds and Turkey

An unusual new friendship

Feb 19th 2009 | ERBIL
From The Economist print edition

Turkey and Iraq's Kurds are getting on a lot better than usual

AN AUDIENCE of Turks and Kurds, gathered in Erbil, Iraqi Kurdistan's capital, waited with bated breath as the Turkish consul-general took the stage. He was to address a gathering organised by followers of Turkey's most powerful Sunni cleric, Fetullah Gulen, who has long preached friendship between Turks and Iraqi Kurds. During his short speech, the Turkish envoy, Huseyin Avni Botsali, uttered the word "Kurdish" only twice: a measure of how edgy Turkey still feels about the Iraqi Kurds' autonomy and the impact it may have on its own 14m-odd Kurds. That is also why Mr Botsali is based in Mosul, a dangerous city in Arab Iraq, rather than in Erbil, in the safety of Iraqi Kurdistan.

Yet Mr Botsali's public appearance before the Kurdish flag marks a shift in Turkey's approach to Iraq's Kurds. Until recently Turkish generals would mutter warnings about invading the Kurdish enclave "if need be" to strike rebels of the separatist Kurdistan Workers' Party (PKK), a group of Kurdish Turks who attack Turkey's forces from bases in Iraqi Kurdistan. Iraq's Kurds suspect that Turkey's real plan is to end their 17-year-old experiment with self-rule.

Nowadays, even Turkey's chief of the general staff, Ilker Basbug, admits that military might alone will not fix Turkey's Kurdish problem. Turkish officials, who used to dismiss Iraq's Kurdish leaders as "tribal upstarts", privately concede that part of the solution is to co-opt Iraq's Kurds. In the past year Turkish intelligence men and diplomats have held secret talks with Nechirvan Barzani, the Iraqi Kurdish region's prime minister, to get the PKK to call off its fight, even as Turkish aircraft continue, with America's blessing, to pound rebel strongholds near Iraq's mountain border with Iran. One idea is that rebels untainted by violence might be coaxed home and their leaders offered cash inducements to move to any European country that would take them in. Turkey could perhaps then formalise ties with Iraqi Kurdistan, among other things by opening a consulate in Erbil.

That would make a virtue of necessity. The chamber of commerce of the mainly Kurdish city of Diyarbakir in south-east Turkey reckons there are about 50,000 Turkish citizens and 1,200 Turkish companies based in Iraqi Kurdistan, doing trade worth some $7 billion a year.

America is lobbying both sides to mend fences, while nudging Iraq's Kurds into squeezing the PKK. President Barack Obama has telephoned his Turkish counterpart, Abdullah Gul, to praise "the growing Turkish-Iraqi relationship". Friendship with Turkey would enable Iraq's Kurds to export their oil and gas and to check Iran's influence in the region. It might even give the Iraqi Kurds a security umbrella once America leaves.

The last big sticking-point is the disputed oil-rich province of Kirkuk, which hosts a large minority of Turkmens, cousins of the Turks who settled there under the Ottoman empire. Turkey wants the Kurds to renounce their desire to incorporate it into their region—something they will not do in a hurry, if ever.

Russia

Stalled factories and fireside chats

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From The Economist print edition

The Kremlin belatedly recognises the full scale of the economic crisis

Illustration by Peter Schrank

RUSSIA'S president, Dmitry Medvedev, has taken to giving televised fireside chats about the financial crisis. Not before time. As unemployment spirals, industrial production slumps, inflation gallops, the rouble slides and the budget creaks, ordinary Russians are wondering what is going on. Polls show that many—over half the population—have little idea of what the government is doing to help them.

When Russia's oil-fuelled economy began to slump last autumn, later than many other countries', the Kremlin stifled public debate, dismissively blaming America for "infecting" the world. The infection proved catching, though, and soon world oil prices slid and hundreds of thousands of Russians lost their jobs. Peremptory silence no longer works. "It is very important to tell the truth," Mr Medvedev now tells Russians on state television. The Kremlin has become more candid about the severity of their economic condition. Having spent weeks predicting that the economy would show zero growth or perhaps a small contraction this year, the economy ministry now admits it will "probably" shrink by 2.2%. That, it says, is because investment in 2009 will fall by 14%.

For a country that has boomed for the past eight years, with annual GDP growth reaching 8%, this is a particularly harsh blow. Independent economists think that even a 2.2% contraction in GDP is wildly optimistic. Depending on the price of oil, it could shrink by 5% or even 10% of GDP. The two main stockmarket indices have lost nearly 80% since their peak last year. The rouble has lost more than 30% of its value against the dollar. At the same time the price of food, most of which is imported, has continued to rise.

The falling oil price is causing other problems, too. Officials have said Russia faces a budget deficit this year of around 8%. Mr Putin has spoken of "optimising" the budget. Even the 2014 Winter Olympics in Sochi, which the Kremlin hopes will bring glory and gold, will have its budget cut by 15%. Nevertheless, the belt-tightening has not stopped Russia from doling out billions of dollars' worth of loans to former Soviet republics such as Kyrgyzstan and Belarus to extend its geopolitical interests.

The Kremlin has also spent over $200 billion of its reserves to cushion the devaluation of the rouble and avoid public panic. It still has more than $380 billion left, the third-largest reserves in the world, prompting a fierce debate over how best to use them. Some, like Moscow's mayor, Yuri Luzhkov, are frustrated that so much of the money seems to have been held back and want it to be poured into the economy. Others, such as the liberal finance minister, Alexei Kudrin, disagree. About 500,000 Russians are waiting to be paid late wages, which, with inflation running at 13%, are fast diminishing in value. Many more have seen the factories on which their livelihoods depend cutting production or even halting assembly lines. The conveyor belt at the giant Avtovaz car factory, which produces the ubiquitous Lada, has spent much of this year motionless. In January industrial output plummeted by 16%, its steepest fall in years.

Russia's unemployment rate rose to 7.7% in December, the highest rate since November 2005. That, the government said, meant 5.8m Russians were out of work. The unofficial unemployment rate is, however, much higher and many Russians who say they have jobs are in fact on indefinite unpaid leave. Even oligarchs are feeling the pain. A new rich list published by *Finans* magazine said the number of dollar billionaires had fallen by more than half to 49 because of the crisis.

There are some signs of discontent. In the far-eastern port of Vladivostok, thousands have taken to the streets to protest against higher import tariffs on second-hand Japanese cars, the sale of which is the backbone of the local economy. In a sign of the Kremlin's nervousness, riot police from Moscow have been sent to deal with the trouble. Pundits predict more unrest in towns, of which there are many in Russia, that rely entirely on one ailing factory or industry. But so far the signs are limited.

That said, the economic misery may be taking the shine off the stellar ratings of Mr Medvedev and Vladimir Putin, now prime minister, even though opinion polls suggest they still enjoy approval ratings well above 65%. The Kremlin's obscure politics are stirring too. Some see Mr Medvedev's new activity as an attempt to pull away from Mr Putin's influence. Others think the prime minister is pushing him forward to take the opprobrium. Either way, heads have begun to roll. Mr Medvedev has fired four regional governors. More sackings can be expected as the economy sinks.

Ukraine's economic slump

Default options

Feb 19th 2009 | MOSCOW
From The Economist print edition

Leaders bicker as the economy sinks

AP

THE D-word is stalking Ukraine. As its political leaders bicker, investors are having nightmares about its defaulting on its sovereign debt. Yulia Tymoshenko, the prime minister, has sought to calm rising investor panic, suggesting that nothing in the government's finances warrants "pronouncing the word default". For now, most experts agree. Even though the markets are charging exorbitant annual rates (32%) for Ukrainian dollar debt (see chart), the coffers seem sturdy enough. Sovereign debt accounts for only about one-fifth of total external borrowing of around $105 billion. The government can handle that, at least this year. But an inevitable series of corporate and banking defaults are likely to hasten the economy's decline.

By now Ukraine should have received the second tranche of a loan from the IMF worth $1.8 billion. But the IMF says Ukraine is not sticking to the conditions of the loan—worth a chunky $16.4 billion in total—and wants greater fiscal discipline. Uncertainty about whether the rest of the loan will be disbursed is causing jitters. But as tension mounts, the president and prime minister are at one another's throats. President Viktor Yushchenko recently, for the umpteenth time, accused Ms Tymoshenko of "betraying national interests", by talking to the Kremlin about a $5 billion loan. Playing the anti-Russian card is one of his favourite ways of wooing public opinion in western Ukraine, where there is little love of Russia or its language.

Ms Tymoshenko is resisting IMF pressure to balance this year's budget, forecast to show a deficit of 3% of GDP. Cutting the deficit would force her to scrap some of the social promises she had made to voters. Mr Yushchenko and Ms Tymoshenko are expected to contest a presidential election in the coming year, and both are playing politics while the sickly economy gets sicklier. Dependent on steel, fertiliser and chemical exports, Ukraine has been hit hard by the global slump in commodity prices. Officials say that industrial output crashed by a jaw-dropping 34% in January year-on-year. Valery Litvitsky, an adviser to Ukraine's central bank, estimates the economy contracted by as much as 20% in January alone, as a dispute with Russia over gas prices reduced supply and forced the country's heavy industry to go slow.

The number of Ukrainian banks going bust is meanwhile growing; many Ukrainian workers are on unpaid and indefinite leave; and the currency, the hryvnia, has shed over a third of its value since the autumn. That has made life tough for consumers, many of whom have borrowed in dollars to buy houses and cars.

To make matters worse, Ukraine is now without its experienced finance minister, Viktor Pynzenyk, who has resigned complaining he had become "a hostage to politics". Opposing the deficit, he refused to approve the budget, and suggested that the government's overall economic plan was unrealistic. The government is still forecasting that the economy will grow slightly this year, by 0.4%, compared with 2.1% last year. But economists say it will probably contract by around 5% or even 6%.

Ms Tymoshenko is trying to borrow money wherever she can. Her government has sent begging letters to America, the EU, China and Japan, as well as Russia. And she is trying to muster a show of unity for the IMF. She wants Mr Yushchenko to join her in signing a declaration expressing readiness to co-operate with

it. To escape this crisis, Ukraine does indeed need the squabbling duo to set aside their rivalry: and not just for show.

Italy

Silvio's good week

Feb 19th 2009 | MILAN
From The Economist print edition

The prime minister rides high as the opposition leader resigns

IT COULD so easily have been a disastrous week for Silvio Berlusconi. Judges in Milan were winding up yet another trial that raised grave doubts about the prime minister's probity. And with Italy feeling the full brunt of the global economic downturn—the country's GDP dropped 2.6% in the last quarter of 2008—he faced a stiff test in regional elections in Sardinia.

But the prime minister is still grinning. On February 17th Walter Veltroni, the leader of the biggest opposition group, the Democratic Party (PD), stepped down after his party suffered a humiliating defeat in Sardinia. Even better for Mr Berlusconi, the resignation distracted attention from the judges in Milan, who sentenced his former adviser on offshore finance, David Mills—a lawyer and the estranged husband of a British minister, Tessa Jowell—to four and a half years in jail on bribery charges linked to Mr Berlusconi.

Mr Mills was convicted of taking a $600,000 payment for withholding evidence at two trials in the 1990s in which Mr Berlusconi, then the opposition leader, was a defendant. Mr Berlusconi had at first been indicted for paying Mr Mills the bribe. But last July his government passed a law giving him, along with the president and the heads of the two parliamentary chambers, immunity from prosecution.

Mr Mills is appealing against the sentence, and Mr Berlusconi is not yet out of the woods. The constitutionality of his immunity faces a legal challenge. In the meantime, his followers have prepared another possible escape route. A clause in a bill to reform the legal system seeks to ensure that the findings of one trial cannot simply be applied to another. So if Mr Berlusconi were again to be tried, the prosecutors would have to start all over again.

For now attention is focused on the ructions within the opposition PD. Renato Soru, the incumbent PD governor and founder of a successful internet firm, Tiscali, was roundly defeated in the Sardinian elections by a challenger from Mr Berlusconi's centre-right movement. The PD's tally was a dire 24%, almost a third less than its share of the vote in Sardinia in the general election last April.

Mr Veltroni's resignation was a tacit acknowledgment that his 14 months as leader have been an almost unmitigated failure. Shortly after he lost the general election, his candidate for mayor of Rome was trounced. His plan to co-operate with Mr Berlusconi to push through reforms in the national interest was humiliatingly swept aside by the prime minister. And from the outset the leader of a smaller opposition party, Antonio Di Pietro, showed a better grasp of how to attack Mr Berlusconi. Mr Veltroni was, it is true, constantly undermined by Massimo D'Alema, a PD baron and former prime minister whose refusal to take a back seat weakened the centre-left.

Who might replace Mr Veltroni? Among the front-runners is a tough former industry minister, Pierluigi Bersani. But he could prove a bit too dour for Italian voters. A lot of left-leaning voters would like to see a new face, perhaps a young and dynamic entrepreneur to take on the tycoon-cum-premier. The 51-year-old Mr Soru might have been ideal, had he not suffered such a drubbing.

Spain's opposition

Scandals as bitter as a traitor's kiss

Feb 19th 2009 | MADRID
From The Economist print edition

Sleaze and disunity trip up the once-confident People's Party

THE Spanish prime minister, José Luis Rodríguez Zapatero, may be presiding over an economy in sharp recession. Yet the opposition People's Party (PP) can scarcely make its criticism heard over the din of its own scandals.

Polls predict that, despite unemployment running at 14%, Mr Zapatero's Socialists will gain votes in two elections on March 1st for regional governments in Galicia and the Basque country. In Galicia, the Socialists may once again form the government; in the Basque country they may lead it for the first time in 25 years.

That would be a blow to the PP leader, Mariano Rajoy, himself a Galician. He has already lost two general elections and his party, unsurprisingly, seethes with barely contained rebellion. His leadership, ever at risk, has been undermined by a bewildering succession of scandals. A controversial investigating magistrate, Baltasar Garzón, has jailed three businesspeople close to the PP. Newspapers talk of bribes and backhanders to party officials in town halls and regional governments. A former senior PP official in Galicia is now in prison; a PP mayor from Boadilla del Monte, a town near Madrid, and a member of the PP-run Madrid regional government, have resigned; and deals done in Valencia, another region run by the PP, are also under legal scrutiny.

All this has exposed the intensity of the party's in-fighting. Judge Garzón's investigation was prompted, it is reported, by the recording of a conversation handed in by disgruntled PP members. A secondary scandal, in which senior PP members from Madrid have been spied on, points to almost paranoid mistrust within the party.

Mr Rajoy denies that any dirty money has gone to the PP's coffers. "I give my word that the party has not financed itself with this corruption, not that I know of," he says. The PP likes to cast itself as victim—of the press, the judge, the government and unscrupulous businessmen. The party's octogenarian founding president, Manuel Fraga, goes one further, citing Judas's betrayal of Jesus. "If Jesus Christ can have something like that happen with his personnel selection, imagine what mere mortals can do," he says.

Time, and the courts, will reveal the scale of any wrongdoing. The political damage, however, is already apparent. Perhaps most upsetting for PP loyalists are newspaper photographs of three of those under investigation, dressed in tailcoats or gowns, as guests at the wedding of the daughter of José María Aznar, the former PP prime minister.

Mr Aznar's eight years in power, ending in 2004, are regarded as the party's high point. There is no suggestion that Mr Aznar is involved in any scandal. But to have his lustrous image tarnished, even just by casual association, is as painful to party stalwarts as a traitor's kiss.

Tax havens

Not-so-safe havens

Feb 19th 2009 | BRUSSELS
From The Economist print edition

The financial crisis is rattling European tax shelters

JUDGED by appearances, Europe's tax havens seem to promise safety from economic tempests. Some are built around sun-drenched harbours, fringed by palm trees. Others nestle in mountain valleys, or quaint towns guarded by the castles of hereditary rulers. Yet even these pretty shelters are now being lashed by the global financial storm.

The European Union is mounting a renewed campaign against tax havens deemed to be unco-operative ahead of a meeting of G20 countries in April. On February 10th ministers demanded the reopening of negotiations with Liechtenstein on fighting fraud. A few days earlier, the European Commission proposed abolishing banking secrecy within EU states in cases of suspected tax evasion.

Three EU members still defend banking secrecy: Austria, Luxembourg and (with less vigour) Belgium. They enjoy exemptions from rules that allow EU members to share information about accounts held by each other's citizens, ensuring that they cannot avoid tax by banking their money in another European country. Instead, the three holdouts allow non-residents to have a "withholding tax" deducted (20%, rising to 35% after 2011). The proceeds are then remitted anonymously. Similar arrangements exist in Switzerland, Liechtenstein, Monaco, Andorra, San Marino and some British and Dutch dependent territories.

Bringing the EU holdouts into line would increase pressure on other havens to open up, though it will not be easy: tax policy in the EU must be agreed unanimously. The fact that the commission is trying is telling in itself. It acted under intense pressure from Germany, France, Britain and a few others, prompted in their turn by a banking scandal last year in Liechtenstein, which is not a member but enjoys access to the EU's single market. The homes and offices of several German business leaders were raided amid allegations that they had concealed up to €4 billion ($5.1 billion) in secret foundations set up by LGT Group, Liechtenstein's largest bank.

The EU had been about to sign an agreement with Liechtenstein to curb fraud when America negotiated a tougher deal for itself, requiring Liechtenstein to give more detail about American citizens suspected of tax evasion there. EU finance ministers now want the commission to match or better that.

Liechtenstein's new prime minister, Klaus Tschütscher, wants the EU to sign the existing deal and defer further changes until EU tax rules are altered to help his country's exports. He is unlikely to get his way at a time when European governments face falling tax receipts—and when voters are in no mood to help fat cats who tuck earnings away in tax havens, no matter how pretty they may be.

Charlemagne

Unruly neighbours

Feb 19th 2009
From The Economist print edition

Europe wants more non-Europeans at the top table. But who should make way?

Illustration by Peter Schrank

LORD, make us selfless, but not yet. That prayer, with apologies to St Augustine, fits many European leaders all too well, as they debate big changes to global economic governance. The pieties have been flying thick and fast, as Europe's bosses talk of the need to take more heed of emerging economies. Europe, goes the argument, is sympathetic and open to the idea of reforming an order that has been dominated for too long by Western countries. That is why Europe is now so keen on the G20, a hitherto rather obscure group of developed and emerging countries.

This has become the new darling of officials in London, Paris and other EU capitals. Leader after leader has stressed the importance of the G20 summit in London on April 2nd, claiming to see a special "European" tinge to its agenda to reform the financial system and pay more respect to rising economic powers like China, India and Brazil. Gordon Brown, the summit's host, says he wants fellow leaders to agree to overhaul bodies such as the IMF and the World Bank so that poorer countries do not simply "reject" these institutions as mouthpieces for the richest states. Other EU leaders have warmed to this self-righteous theme. It was Europe that "demanded" a G20 format for the summit in London, President Nicolas Sarkozy of France boasted in December; Europe has spoken with "one voice". He says Europeans want a return to a "moral" capitalism that serves entrepreneurs, not speculators, and new financial rules that create "a different place" for emerging nations.

Stirring stuff. It must be hoped, therefore, that world leaders can see the joke when they arrive in London, and discover quite how many Europeans it takes to speak with one voice. It is a long list. The world's "top 20", among them the American president, Barack Obama, making his first trip to Europe, will be sitting among a crowd of Europeans jostling for prominence. To begin with, the leaders from Britain, France, Germany and Italy will be present as members of the G7, until recently the elite club of industrialised countries. Then there will be the Czech prime minister, Mirek Topolanek, present as holder of the rotating presidency of the European Union.

He will be flanked by the president of the European Commission, José Manuel Barroso. Also in attendance will be the prime ministers of Spain and the Netherlands, whose countries are not formally members of the G20 but who waged an intense diplomatic battle last autumn to be invited to a preliminary summit in Washington. (The Spanish campaign became a national obsession, with the prime minister at one point flying to Beijing to press his suit, while Spain's king lobbied leaders in Latin America.) One summit seat will go to the French politician, Dominique Strauss-Kahn, who now runs the IMF (a post which is traditionally reserved for a European). Another belongs to Mario Draghi, the governor of the Bank of Italy, who chairs the Financial Stability Forum (a body of central bankers and financial regulators dominated by the G7).

It is all rather a paradox. Just as the European Union demands a greater voice on the world stage, because of its supposed unity and openness to new forms of multinational co-operation, individual members of the club fight ever harder for national seats at the table. (In Warsaw, some senior figures grumble that Poland should be at the G20, to represent former communist states.)

Senior Dutch and Spanish officials stoutly make the case for their inclusion. Both have bigger economies than many full G20 members, and are especially hefty players in international finance and banking. But both the Spaniards and Dutch admit that the current crush of Europeans is “the worst of all possible worlds”. They say they would like a “big bang”: a move to a single EU representative in the G20 (even in the IMF or on the UN Security Council). But that would mean the biggest EU countries giving up privileged national seats, which is unrealistic.

Among EU diplomats, next to no credence is given to claims by the big countries to speak for the rest of Europe; London, Paris and Frankfurt are rival financial centres with their own ideas of how to run finance. Moreover, in recent weeks contrasting national instincts and antipathies have come to the fore. Talk to French officials, say, and their impatience with the Czech presidency of the EU is barely concealed (this was true even before Mr Sarkozy and Mr Topolanek had a public row about whether it was “acceptable” for French firms to build cars in the lower-cost Czech Republic). Italy’s lacklustre stewardship of the G7, which it currently steers, is seen by many officials as all too emblematic of the declining fortunes of that body.

The poison of protectionism

Everybody agrees that protectionism is a menace as the economic crisis deepens, but very different approaches are proposed. On February 18th Henri Guaino, a top aide to Mr Sarkozy, called for common agreement on “reasonable” forms of state intervention and protection, to forestall demands for “the most unreasonable” and “xenophobic” forms of protectionism. This is politics as homeopathy: using bad ideas in small doses, in the hope of staving off a nastier ailment. Ministers from places like Germany, Britain and the Nordic countries regularly speak out against protectionism, yet indulge in quiet forms of intervention to prop up favoured banks and industries. The EU competition commissioner (a tough Dutchwoman) has warned governments against “stealing jobs from one’s neighbours” by “bribing multinationals” with money to protect "national" jobs.

In other words, there is a cacophony in Europe. EU leaders say they understand how damaging this is, and how the current overrepresentation of Europe—from membership of the G20 to voting rights at the IMF—will not be tolerated by other countries for ever. But are they ready to practise what they preach? All the signs are: not yet.

The Home Office

Tough justice

Feb 19th 2009
From The Economist print edition

Jacqui Smith would be in less trouble if Labour's macho crime policy was working

PA

"SOFT and flabby" was how the Conservatives described Labour's approach to crime in 1992. Tony Blair's response was the trademark slogan that Labour would be "tough on crime, tough on the causes of crime". Gordon Brown, his successor, has similarly sought to out-tough his political foes.

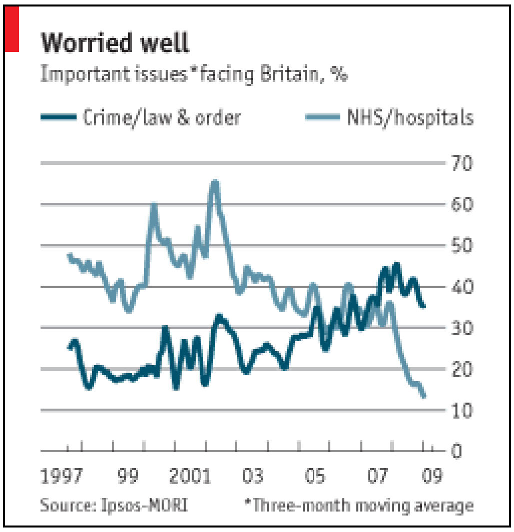
But if Labour has mastered the language of law and order, its home secretaries have been remarkably accident-prone. Jacqui Smith, given the job by Mr Brown in 2007, is now facing a parliamentary investigation into her expenses as an MP. That might be survivable, but it follows a build-up of bad news: anonymous whingeing by unnamed officials that she is no good at her job; complaints about her role in a bizarre police raid on a Tory MP in Parliament in November; and this week an accusation by Dame Stella Rimington, a former head of MI5, that the government has been exploiting fear of terrorism to pass laws that infringe civil liberties.

The office of home secretary has proved a reliable ejector-seat under Labour. Three of the men who did the job before Ms Smith were forced to make unceremonious exits after each walked into a succession of booby-traps. Crime, immigration and terrorism make up a beat that does not forgive mistakes or make for easy policymaking. Advice from experts on matters such as drugs policy is repeatedly at odds with what much of the public and the press demand. "The gap between the evidence and what governments actually do is bigger than in any other department," reckons Chris Huhne, home-affairs spokesman for the Liberal Democrats.

The difficulty of the job is sometimes blamed on an unwieldy bureaucracy, which has a nasty habit of losing track of criminals and fluffing immigration numbers. But, if anything, the Home Office may be becoming an easier ship to steer. An internal review last year noted big improvements since 2006, when the department was ranked among the worst-performing in Whitehall. Hiving off many of its functions to a new Ministry of Justice in 2007 has meant that the justice secretary now takes the flak for escaped prisoners, stroppy judges and unpopular European court rulings, among other things.

That troubles persist at the Home Office is partly because the issues it deals with now worry the public much more than before. The economy may be most people's top concern at the moment but, remarkably, the issue of law and order seems to bother voters

more even than health, which used to matter much more (see chart). The political landscape has changed: Tim Newburn and Robert Reiner, criminologists at the London School of Economics, note that until the early 1970s crime was scarcely a partisan political issue at all. Labour's attempt to match the Conservatives on law and order has made it a new, vicious battleground, raising the stakes for home secretaries considerably.



Criminalising Britain

But it is increasingly the content of Home Office policy, as well as its saliency in the public mind, that seems to be destabilising ministers. Labour's hyperactivity on law and order has spawned some 50 acts of parliament and introduced more than 3,500 new offences. In the latest example, a law that came into force on February 16th makes it illegal to take a photograph of a policeman without a "reasonable excuse", on the grounds that the snap could prove useful to a terrorist. The government has learned to live with the miaows of civil-liberties outfits—indeed, Ms Smith sometimes seems to enjoy standing up to them. But criticisms from people like Dame Stella are proving harder to shrug off.

The majority of voters, it is argued, are not troubled by the six counter-terrorism acts that Parliament has passed in the past nine years, and that is what matters. But Labour's unapologetic occupation of the tough territory may have caused hidden damage. Although polling suggests that most voters support the wide-ranging new powers that the government has bestowed upon the police, they also show that trust in the police has fallen. Whereas in 1982 some 92% of people said their local bobbies were doing a very or fairly good job, by 2003 less than 75% did. (The Home Office then discontinued that particular question.)

Labour's unswerving determination to press on with other stern security measures may also be backfiring. Although a slender majority still supports plans for a national identity-card scheme, most people by a margin of nearly two to one are against the collection of more personal information by the government. (Some proponents of ID cards now wish the scheme had been handled by the less gung-ho communities department.) It may be that early public support for "tough" law-and-order initiatives belies deep unease about the principles behind them.

More straightforwardly, it may be that the public has come to doubt Labour's ability to turn bold promises into results. The number of police on the payroll is a quarter higher than when Labour came to power, but the officers are less visible than before thanks to a heavy increase in paperwork. Although there have been significant long-term falls in crimes such as burglary and car theft, some serious offences, notably violence among teenagers, have increased in some areas. And as Dame Stella and others suggest, the multiple new anti-terror laws have not done much to make people feel safer.

Ms Smith's allies represent the attacks on her as a distorted form of personality politics. They are provoked, it is said, by nothing more than a desire among Tories to claim a high-profile scalp, and the increasingly personal tone reflects frustration that there is nothing more substantial to criticise. Certain right-wing newspapers allegedly see Ms Smith as "the new Cherie Blair": an uppity woman to be brought down a peg or two.

But there may be more to her travails than this. Labour's grim determination to outflank its opponents on law and order may once have made political sense. For its first five years in office, Labour outdid the Tories in polls on which party was better at handling crime. However, it seems now to be reaping diminishing returns: since 2003 the Conservatives have been ahead again, recently by as much as 19 percentage points. The public wants to be protected, but it also wants to be convinced that the price of that protection is worth paying.

Lloyds Banking Group

Thanks, Gordon

Feb 19th 2009
From The Economist print edition

Why bankers should beware prime ministers promoting mergers

Reuters

Black times for the Black Horse

FOUR months after the government's dramatic and widely acclaimed rescue of the banking system, things are not going to plan. In particular, the hastily arranged marriage of two big banks, Lloyds TSB and HBOS, is teetering on the brink of full-scale nationalisation.

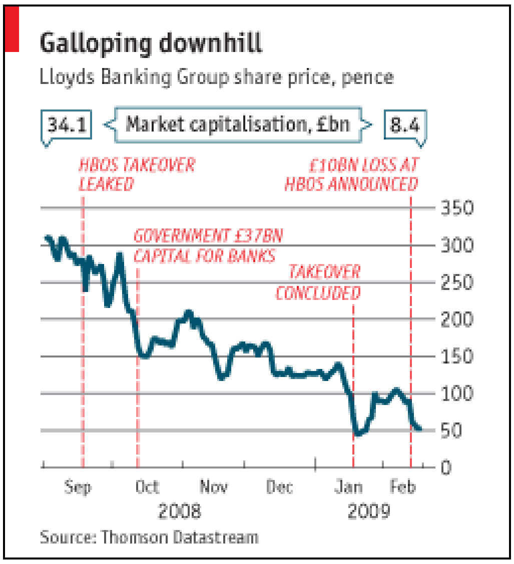
That takeover by Lloyds, promoted by Gordon Brown, was supposed to provide a safe haven for troubled HBOS. Instead it threatens to bring down the now combined Lloyds Banking Group (LBG). An announcement by LBG on February 13th of a higher than expected loss of £10 billion at HBOS in 2008 alarmed the City. Since LBG is already 43% owned by the government following last autumn's emergency injection of extra capital, it would not take much to push it towards majority public ownership, as has already happened with Royal Bank of Scotland (RBS), which is 70% state-owned.

The merged bank's Achilles heel is the corporate-loan book of HBOS. Lloyds TSB was a reasonably sound bank, making a profit of around £1 billion in 2008 despite the crisis. By contrast, HBOS, the result itself of a merger in 2001 between Halifax, the country's biggest mortgage lender, and Bank of Scotland, had adopted an unsound business model, in particular by aggressively pursuing market share in commercial property. Now many of the deals in its £45 billion commercial-property portfolio have turned sour. There are also fears about hefty losses in HBOS's huge mortgage-loan book, as house prices continue to fall and unemployment increases by leaps and bounds.

It seems that Lloyds TSB was blinded to these lurking dangers by the prospect of adding such a huge market share when a collapsing HBOS fell into its lap last September. The government was so keen on the rescue bid that it promised to waive competition rules, which had blocked Lloyds' proposed merger with Abbey National bank in 2001, even though that was a much smaller affair.

Eric Daniels, LBG's chief executive, still insisted on February 11th that "it was a good deal for Lloyds TSB". However, that was before the announcement of fresh losses which sent the share price plunging and triggered a downgrade in its prized credit rating from Moody's. A long-term perspective is that LBG will indeed begin to make fistfuls of money in two or three years' time because of its dominant position in the British market for mortgages, insurance and deposits. But if the government has by then built up a majority stake it will prevent LBG from exploiting that dominance to the extent that Mr Daniels might have hoped.

The prime minister, for his part, insists that he does not want to nationalise LBG. Indeed the move would be politically disastrous for him since the government did so much to facilitate the merger. Sir Victor Blank, the chairman of Lloyds TSB, and Mr Brown are said to have concocted the deal at a drinks party.



Yet the Treasury's insurance scheme for banks' dodgy loans could well lead to public ownership for LBG. Under that plan the government will shoulder much of the risk of big losses on those toxic assets in return for a payment. The share price of RBS took a tumble on February 18th on fears that the bank might seek cover for as much as £200 billion of its bad assets, resulting in a fee of £8 billion which would require yet another call on public funds.

The government's role in the banking crisis will be in the limelight on February 25th. Two chiefs from Gordon Brown's brainchild, the Financial Services Authority (FSA), to which he handed banking supervision from the Bank of England, will face questions from the same parliamentary committee that hastened the departure of Sir James Crosby, a former boss of HBOS, from his job as vice-chairman of the FSA. Quite apart from its poor performance over Northern Rock, a mortgage bank nationalised after months of government dithering, the FSA faces criticism for focusing on the wrong things—spending too much time on box-ticking and too little on where the big dangers lurked.

But the larger political danger for Mr Brown remains the fate of LBG. Clearly the directors of Lloyds TSB must take responsibility for their decision to acquire HBOS. But if LBG is forced into public hands, then the prime minister's critics will say that his overhasty assistance dragged a sound bank down with HBOS.

Labour's predicament

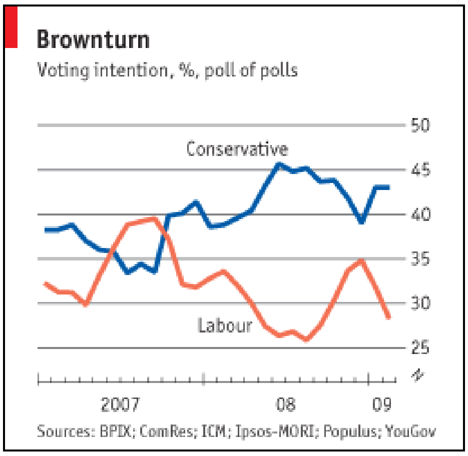
Point of no return?

Feb 19th 2009
From The Economist print edition

Gordon Brown will be hard-pressed to clamber back in the polls

DEAD-CAT bounces are not confined to stockmarkets. Gordon Brown's electoral recovery late last year has been extinguished, with polls that showed Labour close to the Conservatives now registering strapping Tory leads (see chart). On February 16th a survey by Ipsos MORI recorded a landslide margin of 20 percentage points.

The prime minister's electoral prospects surged again last autumn as he steadied the financial system with a plan copied by other countries. His standing was enhanced by the absence of American leadership as power ebbed away from George Bush. But that fillip is now gone and the severe recession is grinding away at Labour's standing. The prime minister's charge that the Tories are a "do-nothing" party has been blunted, as his frenetic policy activism begins to look ineffectual in the face of mounting job losses.



This is a fraught moment for Mr Brown, who must face a general election no later than June 2010. When governments lose hope of re-election, ministers position themselves for the leadership contest that inevitably follows the return to opposition. Such in-fighting further diminishes the authority of the government.

On cue, recent cabinet meetings have featured discord over a third runway at Heathrow and over economic policy. Earlier this month Frank Field, a former minister and long-time critic of Mr Brown, pointed to "the emerging faultline in New Labour" in tackling the financial crisis. Some ministers want a tougher approach to the banking sector in word and deed (for example, by clamping down on bonuses), while others, with an eye on the party's hard-earned reputation for supporting enterprise, counsel restraint.

These differences herald a broader debate over Labour's economic policy that will probably unfold in a future leadership race. The split is "more generational than ideological", according to one MP: some young ministers, even those on the right of the party, are more relaxed about facing down business than are older hands, such as Lord Mandelson, who bear the scars of the fight to rid Labour of its noxious association with national ownership in the 1980s and 1990s. Ministerial manoeuvring is exaggerated, maintain some in the party. But Conservatives brandish Lord Mandelson's warning against anti-bank fervour, delivered in New York on February 17th, as proof of a split government.

Whatever the divisions, some hopeful Labour souls insist that, if Mr Brown can fight his way out of a bleak predicament once, he can do it again. The coming months include opportunities for the prime minister to shape events, such as the G20 summit in London in early April and the budget later that month. Mr Brown could also try expressing a bit of remorse for what has gone wrong economically and financially on his watch, though he would find it hard to stomach the glee with which the Tories would greet such an apology. Another idea, put forward by Matthew Taylor, who once headed Tony Blair's policy team, is for the prime minister to strive to rise above party politics by refraining from attacking the Tories while the recession continues.

But Mr Brown will find it harder to stage a second comeback, not least because an American president is once again dominating the world stage. The prime minister's resilience is remarkable: few believe he will quit soon to accept a new role as an international financial regulator, as mooted in the British press this week. And the public are not keenly awaiting a Conservative government in the way they looked forward to Labour's election in 1997. Yet barring a *deus ex machina*, such as a foreign-policy crisis, a Tory super-scandal or an improbably rapid economic recovery, a route to victory for the government at the next election is increasingly difficult to envisage.

Reforming primary education

Competing visions

Feb 20th 2009
From The Economist print edition

Academics and ministers differ on what is to be done

LIKE buses, not just one but two reviews of primary education in Britain are arriving at the same time. Their titles may be similar but they could hardly differ more.

The Cambridge Primary Review was independently conceived and financed, has been years in the planning and execution, and draws on international evidence and scores of experts. Its final conclusions, due later this year, will synthesise 30 research surveys on all aspects of primary education. The Primary Curriculum Review, by contrast, was commissioned and paid for by the government and is the sole work of a serial government-report writer, Sir Jim Rose. He was asked to look at only the curriculum—not standards, testing or funding—and within that limited remit he was constrained by a tight brief and heavy hints as to the desired conclusions.

On February 20th the Cambridge-led team abandoned their publishing schedule and released the part of their final report that looks at the curriculum. It hopes, somewhat forlornly, to influence government policy. That seems unlikely. The official curriculum agency is already far advanced in creating teaching material along the lines Sir Jim recommends—even though only his interim report has appeared, and that is supposed to be open for consultation until February 28th.

The two reviews set out competing visions of how to improve primary education. For Sir Jim, the main problem is curriculum overload, generated by empire-building subject specialists and a repeated reluctance to remove old material when adding new. His solution is twofold: to reaffirm the primacy of a "core curriculum", adding computer skills to the literacy and numeracy now granted this status, and to replace the 12 subjects now taught, plus the foreign language soon to be added, by six cross-cutting "areas of learning".

The Cambridge team offers a different diagnosis of the problem, and therefore quite different medicine. The problem, they think, is not so much curricular overcrowding, but that a narrow diet of literacy and numeracy has pushed pretty much everything else to the sidelines. School inspections, teacher training, pupil assessment and political populism all reinforce the message that only these "basics" count. That means they are allocated most time and that little attention is paid to the quality of teaching in other subjects. Such dumbing-down is self-defeating, they say: studies show again and again that a broad, rich and balanced curriculum, far from distracting from the basics, is actually a prerequisite for high standards in them.

The independent team are particularly scathing about their rival's "areas of learning", in which they detect a deplorable educational trendiness. "Children do not need to know lots of dates. They can look up information on Google and store it on their mobile phones," said Sir Jim. Not so, say the Cambridge academics. They take his contention as their starting-point for a passionate defence of knowledge as more than facts and information, to be stored or downloaded, but not absorbed, questioned or created. Obvious enough, perhaps, but is anyone listening?

Government jargon

Translating eduspeak

Feb 19th 2009
From The Economist print edition

What they mean when they say

IF YOU know what deep learning and functional skills are, then you are already on the way to understanding eduspeak. But there are other terms that must be grasped to attain an A* in the subject.

Satisfactory. One of the four possible judgments of the schools inspectorate (the other three are inadequate, good and outstanding). It means "unsatisfactory". ("Inadequate" for its part means "dire".) This explains the chief schools inspector's pronouncement that satisfactory schools are "not good enough".

Excellence and **enjoyment** are mutually exclusive. The first is used for what matters (literacy and numeracy), the second for what does not (everything else). "Enjoying reading" and "excelling in music" are howlers in eduspeak.

Non-statutory depends on context. It can mean "optional", but in the National Primary Strategy, a set of "guidelines" on teaching literacy and numeracy, it means "obligatory"—unless a school wants to risk being deemed "satisfactory".

Gifted and **talented** refer to the top 5-10% in academic and non-academic pursuits respectively, who are to be encouraged in their gifts and talents. The terms are necessary as a sop to middle-class parents concerned that their children are not being stretched enough. To deflect the charge of elitism, levelled by many teachers, the categories have proliferated to include the capacity to "make sound judgments", to show "great sensitivity or empathy" or to be "fascinated by a particular subject".

A **specialist school** is a bog-standard comprehensive that has jumped through hoops to get extra government money. Most secondary schools are now specialist. Of these almost as many chose their specialism because they were weak in it and wanted to improve as chose it because they were strong in it. Specialist schools may select just a tenth of their pupils according to aptitude (and then only if their specialism is non-academic, such as sports or technology), which is lucky for weedy children who live near sports-specialist schools, but does rather stop the schools from specialising.

An **independent** government-commissioned review is one whose author is not a civil servant. The remit leaves little room for manoeuvre and the conclusions are wearily predictable. The purpose of such a review, by no means confined to education, is to provide cover for politicians to carry out what they were going to do anyway.

Conservative policy

Lukewarm localism

Feb 19th 2009
From The Economist print edition

The Tories' plans for handing power to local communities are timid

A POLITICAL party that has little to say about the recession risks looking incredible. But a party with nothing to say about anything else may seem unappetisingly glum. Once accused of being deficient on the big economic issue, David Cameron's Conservatives are now trying to avoid the charge of bleak vacuousness on the rest.

This week they sought to flesh out their commitment to "localism"—devolving more power from central to local government and beyond. Among their schemes were granting a "general power of competence" to local councils to improve their neighbourhoods (though it is hard to envisage many of them being imaginative enough to exploit it), and new mechanisms to let councils retain the tax benefits of local business growth and new housing.

Voters would also enjoy new powers under the Tory plans. Since 2000 English cities have been able to opt to elect executive mayors, but no big metropolis outside London has done so. The Conservatives say they will insist on referendums on adopting the mayoral system in the 12 next biggest cities. Voters would elect new local police commissioners, and be able to hold other referendums more easily. They would also get a guaranteed right to vote on large increases in council tax—a stipulation that may render councils' proposed ability to raise it largely notional.

The Tories' professed motives—restoring civic pride, reviving public faith in politics, rebalancing the economy to make it less reliant on London—are a laudable attempt to undo some of the work of Margaret Thatcher. She, in the words of Tony Travers, of the London School of Economics, waged an "11-year-long war against local government". Her successors have gleefully continued to neuter local councils, whose work is now hedged about with central directives and targets. Yet the Tory change of heart would go only a little way to restoring local democracy.

For one thing, as Labour has been quick to point out, most of the Tories' ideas are not quite as revolutionary as they implied. Many derive from existing government initiatives, and others from practice in America and elsewhere. Some, such as the police commissioners, are vague.

More important, the plans do almost nothing to diminish councils' overwhelming and emasculating reliance on central-government funds. On this score the Liberal Democrats have been bolder. It also remains to be seen how a Tory government would respond to the outrage routinely provoked by variations in the quality of local services—the "postcode lottery"—which would presumably become more widespread under their plans.

So the Conservatives are not quite turning "Britain's pyramid of power on its head", as Mr Cameron put it. According to their vision, voters and the media will increasingly hold "local governments, not Whitehall, responsible for the conduct and direction of local affairs". That would be a useful shift in the tight budgetary circumstances that a Tory government would inherit. But it remains unlikely as long as the centre keeps hold of the purse strings.

Railways

Hitting the buffers

Feb 19th 2009
From The Economist print edition

The strain on the train from the economic pain

STANDING at the railway station on a weekday morning in St Albans, a cathedral city in London's commuter belt, rail passengers have plenty to feel miserable about. Their fares are the highest in Europe, according to a report on February 19th from the rail-consumer watchdog. Despite the recession, the platforms are still packed, and commuters' chances of getting a seat on the services into the capital seem as minuscule as ever.

Despite the crammed carriages, the deteriorating economy has train companies worried, for two reasons. Historically, shifts in rail passengers' numbers have closely tracked changes in employment. Passenger numbers fell by over 10% a year in the recession of the early 1980s (the fall was less dramatic in the early-1990s slump, but more prolonged). With the unemployment rate now standing at 6.3% and lay-offs being announced daily, rapid passenger growth—7% last year—is over and the numbers travelling may fall.

Not only that, but the amount they pay may fall as well. The price of many rail tickets, particularly the annual season tickets popular with commuters, is regulated, and most prices cannot rise by more than one percentage point above the rate of inflation in a year. Unlike the Bank of England, which targets inflation using the consumer-price index (currently rising by 3.0%), the train companies rely on the broader retail-price index (RPI), which increased by only 0.1% in the year to January and is heading into deflationary territory. That could mean, *mirabile dictu*, that rail fares will fall.

All this will strain a system of contracts that were negotiated by train firms and the government in a spirit of mutual optimism. Train firms got used to impressive growth in passenger numbers (more people now use the railways than at any time since the end of the second world war). Ministers, alarmed at the rising bill for subsidising the network (currently around £4.5 billion a year), became determined to shift more of the burden on to passengers. That led to a bidding war among rail firms, says Stephen Glaister, an economist at Imperial College, London, where the more heroic assumptions were about passenger numbers and fares, the more likely the bid was to impress the Department for Transport.

That lean times are on the way seems indisputable. Gloomier prognostications suggest that, without a government bail-out, some firms could go bankrupt. But the trains should continue to run (though possibly with some disruption), thanks to special provisions covering bankruptcy proceedings in the rail business. Firms have been unable to fulfil their obligations before: services continued to run on the East Coast line between Edinburgh and London when GNER was stripped of its franchise in 2006. And while rail companies may be groaning, their remaining passengers may have something to celebrate. The combination of cheaper tickets and a seat in the morning is one they have been denied for a long time.

Bagehot

The spiral of ignorance

Feb 19th 2009
From The Economist print edition

Lack of understanding of the credit crunch is magnifying its damage

Illustration by Steve O'Brien

THE BBC's "Today" programme is the main current-affairs show on British radio. Last year it recruited a new presenter, Evan Davis, who is also an economist. An amusing pattern has since developed. Quizzed about the credit crunch, a politician delivers some carefully memorised remark about, say, quantitative easing. Then the guest experiences an audible moment of existential horror, as Mr Davis ungallantly presses him for details.

The tide has gone out and, with a very few exceptions, Britain is swimming naked: almost nobody appears to know what he is talking about. The havoc of the financial crisis has stretched and outstripped even most economists. The British political class is befogged. Ordinary people are overwhelmed. And just as the interaction between banking and economic woes is proving poisonous, so the interplay of public and political ignorance is damaging the country's prospects.

Start with the government, whose ministers are still oscillating between prophesying economic Armageddon and gamely predicting the best of all possible recoveries. Gordon Brown is learned in economic history—indeed, he is at his most animated and endearing when discussing it. But the prime minister's grip on the history he is living through is less masterful. The government's implicit strategy is to try something and, when that does not work, try something else: the approach modestly outlined by Barack Obama, but rather less honest.

The Tories are now capitalising on this flakiness; but for much of the past year, they have seemed at least as unconvincing. It was only a few months ago that David Cameron, the Conservative leader, averred that—since the economy was purring so happily—his historic mission was to mend British society. George Osborne, the shadow chancellor, clung for too long to his fair-weather formula about sharing the proceeds of non-existent growth. Mr Cameron and Mr Osborne are vague about the methods they would employ to repair the public finances in office. That sketchiness might be tactical. Or it might be because they do not know.

The truth is that hardly any MPs in any party have more than a rudimentary grasp of the crisis; indeed, their inability to track the City's baroque excesses helped to foment it. (The intellectual background of

MPs, few of whom have much training in economics or commerce, may contribute to this deficiency.) Vince Cable, the Liberal Democrats' treasury spokesman, has the best record in Parliament of predicting and analysing the debacle—and precisely because he is so lucid, he seems increasingly to be regarded as an impartial pundit rather than a politician.

Meanwhile, the bodies and advisers appointed by the politicians to do the understanding for them have been largely discredited. The Bank of England obsessed about monetary policy and neglected financial stability. Sir James Crosby quit as deputy head of the Financial Services Authority (FSA) amid embarrassing questions about risk-taking at the bank he used to run. The involvement of Glen Moreno—chairman of Pearson, which part-owns *The Economist*—in UK Financial Investments, which manages the government's new stakes in Britain's banks, has been undermined by his association with secretive Liechtenstein.

A layman might conclude that there is almost no one in Britain capable of comprehending the financial mess, and at the same time sufficiently uncontaminated by the mistakes and ruses that caused it to be entrusted with the job of fixing it. (Lord Turner, the FSA's new chairman—who has admitted that financial regulators, among others, missed "an increase in total system risk"—may be a happy exception.) It might help if ministers looked beyond the world of banking, of which they still seem to be in a sort of post-socialist awe, for more of their recruits. The layman, however, may be as much to blame as anyone else.

If financial acumen is limited in the governing classes, it is at least as rare outside them. In surveys, the economy has leapt to the top of voters' concerns; anxiety is rampant, fed no doubt by the unfortunate trend whereby half the things that "experts" say can never happen come to pass within a fortnight. The public seem to appreciate that the crunch involves both foreign and domestic forces. But to most people the rest is a mystery. Along with the high anxiety, this uncertainty helps to explain the volatile political impact of the downturn: large numbers of people seem to be amenable to whatever explanation seems freshly plausible.

First thing we do, we hang all the bankers

The culprits many have now settled on are the bankers. Some of those—unable to accept the reality of their institutions' failure—deserve the opprobrium. But the furore over their bonuses has obscured other realities. One is the fact that, now that taxpayers own some of them, they have an interest in the banks being run by clever people; another is the fundamental role banks play in the economy. And because MPs are instinctively populist, as well as bemused themselves, they too have fixated on bonuses.

It is not only banking about which general knowledge seems poor: the same is true of the concept of money. The nasty little secret of the slump is that by overborrowing and making myopic investments, lots of ordinary Britons helped to bring their difficulties on themselves. Low levels of financial literacy (knowing the difference between an ISA and an iPod, and so on) are part of this problem. But so is the cowardly reluctance of politicians to say unpalatable things.

The philosopher Bertrand Russell once remarked that he knew of only six people in the world who had followed his daunting book "Principia Mathematica" to the end. There sometimes seem to be almost as few people in Britain who truly understand the credit crunch and its recessionary consequences. The public is scared and uncertain; the politicians are panicky and confused. They are leading each other around and down a worrying spiral of ignorance.

Internship

Feb 19th 2009
From The Economist print edition

The Britain section will soon be choosing an intern to work for several months this summer. Applicants should send a letter and an article of about 600 words that they think would be suitable for publication. A small stipend will be paid. Applications must reach patsydryden@economist.com by March 20th.

Economist.com WORLD INTERNATIONAL

Globalisation

Turning their backs on the world

Feb 19th 2009
From The Economist print edition

The integration of the world economy is in retreat on almost every front

Illustration by Claudio Munoz

THE economic meltdown has popularised a new term: deglobalisation. Some critics of capitalism seem happy about it—like Walden Bello, a Philippine economist, who can perhaps claim to have coined the word with his book, "Deglobalisation, Ideas for a New World Economy". Britain's prime minister, Gordon Brown, is among those who fear the results will be bad.

But is globalisation really ending? The world's economies are certainly slowing fast. And the speed and scale of this recession are raising doubts about the assumptions that had underpinned the drive to integrate world markets. At the end of 2008 the IMF said the world economy would grow 2.2% in 2009, less than half the rate in 2007. Now it thinks growth will be just 0.5% this year, the lowest for 60 years. Even that may be optimistic; in the last quarter of 2008, some economies shrank at annualised rates of over 10%.

Nobody ever said globalisation had ended economic ups and downs, but this feels different: *prima facie* evidence of big problems at least, and possibly of the failure of globalisation to deliver many of its advertised benefits, especially to the poor. True, economic slowdown is not the same as deglobalisation. And the slowdown has yet to affect one thing. For years, poor countries have been growing faster than rich ones; so far, they still are. The gap between real GDP growth in emerging markets and in rich countries widened from nothing in 1991 to about five points in 2007—and, says the IMF, it will stay at 5.3 points in 2008 and 2009. Helping poorer countries catch up has long been among the benefits touted for globalisation.

And yet the process is going into reverse. Globalisation means the global integration of the movement of goods, capital and jobs. Each of these processes is now in trouble. World trade has plunged. As recently as the first half of 2008, boosted by rising commodity prices and a falling dollar, trade was growing at an annualised 20% in dollar terms. In the second half of 2008, as commodities sagged and the dollar rose, growth slowed fast; by September, says the IMF, it was in reverse. In December, says the International Air Transport Association, air-cargo traffic (responsible for over a third of the value of the world's traded goods) was down 23% on December 2007—almost double the fall in the year up to the end of September 2001, a result affected by the 9/11 terror attacks.

The downturn has been sharpest in countries that opened up most to world trade, especially East Asia's tigers. Singapore's exports are 186% of GDP; its economy shrank at an annualised rate of 17% in the last three months of 2008. Taiwan's exports are over 60% of GDP; and its economy may fall as much as 11% this year. The downturn has also hurt rich countries that specialise in staid old-fashioned manufacturing—supposedly a safer activity than the reckless delusions of finance. On average, says the IMF, rich countries will contract 2% this year. But Germany and Japan, big exporters of capital goods, cars and electronics, will do worse, their economies shrinking by 2.5% and 2.6% respectively. In the last quarter their economies contracted alarmingly, falling at an annualised rate of 8% in Germany and by 13%—the worst since 1974—in Japan.

Small countries which went into businesses that grew in globalisation's wake, like tourism, are also suffering. The World Tourism Organisation says international tourist arrivals fell 1% in the second half of 2008, which may not sound bad, but compares with growth of more than 5% a year for the previous four years. In the Caribbean, visitors may fall by a third this season; in some islands hotels are half empty, flights are being cancelled and national budgets, reliant on tourism, are strained.

In contrast, the biggest emerging markets are doing less badly so far. In India, where exports are around 15% of GDP, the government recently said growth in the year to April 2009 would be 7.1%; most forecasters put growth for the 2009 calendar year lower, but still about 5%. In Brazil the economy has been harder hit by falling commodity prices and declining exports. Most economists still think output grew a bit in the year to the fourth quarter, and put growth for 2009 at 1.5% to 2%. China was still growing by 6.8% in the year to the fourth quarter, though like Brazil it is probably stagnating. Chinese exports fell 18% and imports 43% in the year to January. All three countries have large domestic markets and relatively stable banking systems, which have not been liberalised.

The gap between toothless tigers and friskier BICs (ie, BRICs minus Russia, a special case because of oil) raises questions not so much about globalisation as a whole—after all, Brazil, India and China have been beneficiaries—as about particular aspects. Can one be too dependent on trade? How far should one liberalise banking? Is there a trade-off between taking advantage of good times and providing shock absorbers for bad ones?

Emerging markets' trade problems have been worsened by shifts in capital flows, globalisation's second big plank. According to the World Bank, net private debt and equity flows to developing countries will fall from $1 trillion in 2007 to $530 billion in 2009, or from 7.7% to 3% of those countries' GDPs. The Institute for International Finance sees an even steeper fall; it says that this year banks will extract more from emerging markets in debt repayments than they inject in new loans. Bond markets in those countries collapsed in the last quarter of 2008, doing less than $5 billion of business; in the second quarter, they had issued about $50 billion of bonds.

As with trade, financial deglobalisation is hitting countries in a variety of ways. In this case, East Asia has been less affected because most countries there are net creditors. But eastern Europe and Russia have been hammered because local banks went on a foreign-borrowing binge, foreign banks piled into their markets (and piled out again) and because some countries lacked insurance policies against tough times. Although many big emerging markets have built up foreign-exchange reserves and cut their external debts, in eastern Europe reserves have been flat, external debts have risen and current- account deficits have grown considerably in the past decade. In these countries, the reversal of globalisation

has exacerbated problems that were building up anyway.

People in emerging markets have mixed feelings about financial liberalisation and may not regret its reversal. But foreign direct investment (FDI) is different. Most people welcome new factories and new jobs. FDI is also one of the commonest routes by which skills and technology are transferred from rich to poor countries.

This, too, is falling. The United Nations Conference on Trade and Development (UNCTAD) says worldwide FDI inflows shrank 21% in 2008 to $1.4 trillion. The World Association of Investment Promotion Agencies says FDI will contract by a further 12-15% this year.

In contrast to trade, the investment impact of the global downturn has so far been hardest on the countries where the woes began: rich ones. They have seen FDI falls of one-third on average and by half or more in Britain, Italy and Germany. Finland and Ireland have seen net outflows. FDI flows to developing countries were still growing in 2008, albeit by only 4%, after a rise of 21% in 2007. Flows to big South American countries were up by about a fifth; those to India more than doubled, though they may ebb as GDP falters.

The third of the three main aspects of globalisation—jobs—is following the other two, with a lag. The International Labour Organisation forecasts that unemployment worldwide will rise by around 30m above 2007's level in 2009. Most of that rise will be the result of recession, not deglobalisation, but some will be attributable to the fall in trade (exporting companies will lay off workers) and some to declining investment (if expansion plans are cut, new jobs will not be created).

Deglobalisation will have a dire impact on migrants. In the past decade, more people have been moving voluntarily than ever before; now, some are going home. Those who provided labour for the housing boom in America (notably Latinos), Ireland (Poles) and China (rural Chinese going to cities on the eastern seaboard) have been among the first to be laid off. In Spain newly jobless builders are competing with migrants there for jobs picking fruit.

This will surely have an effect on the flow of remittances from rich countries to poor ones, although it has so far (see article) been quite resilient. In any case, economies that absorbed large numbers of foreign workers may take fewer. Some of the millions of South Asians who work in the Gulf, or the young Africans who flock to South Africa, or the Central Asians who work in Russia, may have to stay at home.

Yet for all the economic pain, the social and political fallout from deglobalisation has not yet been severe. Protests may still come. Or maybe national governments are absorbing most of the ire. In December, Greece saw riots after a police bullet killed a teenager. In France, unions brought over 1m people onto the streets for a one-day strike, and a riot in Latvia over economic policy ended in more than 100 arrests. But only in Britain, where workers have picketed refineries and power stations over the hiring of foreigners, has protest had a very anti-global tone.

This lag may be explained by residual support for globalisation, especially in emerging markets. A poll in 2007 by the Pew Global Attitudes Project found that majorities in 47 countries saw international trade as good for them; majorities in 41 out of 46 welcomed multinational firms; in 39 out of 47, most felt better off with a free market. In more than half the

Down, down, down but not out

GDP, % change on previous year

World:

Annualised three-month % change

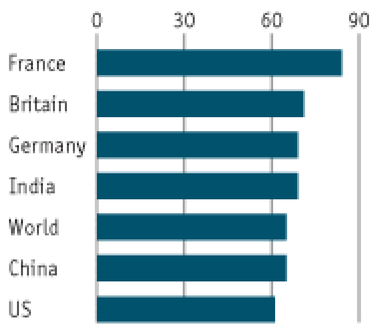
FDI inflows, % change on previous year

2008

Country	Change
Singapore	-57.3
Britain	-51.2
Germany	-48.9
France	-27.7
Japan	-22.7
US	-5.5
China	10.7
Russia	17.5
Brazil	20.5
India	59.6

Respondents who want more government control over business activity

% of total‡



*Estimate †To November
‡Poll of 4,475 people in 20 countries between November and December 2008

Sources: IMF; UNCTAD; Edelman Trust

countries where changes could be tracked, support for free markets was rising.

When consensus wobbles

But is that still true? Last summer, on the eve of the meltdown, European Union pollsters reported that two-thirds of EU citizens saw globalisation as profitable only for large firms, not citizens. In 2002, according to the Pew poll, 78% of Americans thought foreign trade helped the country; by 2007 it was only 59%. A CNN poll in July 2008 showed that, for the first time, a small majority of Americans saw trade as a threat, not an opportunity.

Of the few worldwide polls to have been completed since then, one by Edelman for the World Economic Forum found that 62% of respondents in 20 countries said they trusted companies less or a lot less now. Manifestly, popular opinion backs more state regulation.

So far, this has mostly taken the form of pouring public money into banks and selected industries, notably cars. Last week Barack Obama set out plans for another vast bank rescue, and the French government promised €6 billion ($7.8 billion) in preferential loans to Renault and Peugeot-Citroën in return for pledges that no car factories would be closed in France.

There has been somewhat less evidence of trade protectionism. India has raised some steel tariffs. The EU has reintroduced export subsidies for some dairy products. Russia has raised import duties on vehicles. But there has also been movement the other way. The American Senate softened the “Buy America” provisions of the stimulus bill. Mexico said that by 2012 it would cut tariffs on thousands of kinds of manufacture. And some countries have sought a safe harbour, rather than embracing pure nationalism. East Europeans are even keener on the shelter of the euro; Iceland has applied to the EU; the Irish are more likely than they were to vote for the EU’s Lisbon treaty.

Despite the downturn, the nations of the world have not shunned globalisation. It has been protected by the belief of firms in the efficiency of global supply chains. But like any chain, these are only as strong as their weakest link. A danger point will come if firms decide that this way of organising production has had its day.

Civilians in war zones

Women and children worst

Feb 19th 2009
From The Economist print edition

Much butchery, some retribution

BABIES' skulls dashed against rocks; attempts to twist off the heads of toddlers. Girls, their mothers and grandmothers (and sometimes male relatives too) raped at knife- or gunpoint, the weapons then used to inflict mutilation. Women hauled off to camps or just tied to trees and gang-raped. Thousands of children, some as young as nine, snatched or recruited by armed gangs (or regular forces) and made into drug-crazed killers, the girls among them often serially abused or taken by commanders as "wives".

Such are the horrors reported from some recent conflict zones. In civil wars, women and children always fare worst. But with every new killing-field, from Bosnia to Liberia, Sierra Leone, Congo, the Central African Republic or the Darfur region of Sudan, the level of cruelty seems to shock even the most seasoned observers.

Data on such matters can be hard to get. Take the Central African Republic (CAR), where the UN says child abuse, rape and forced military recruitment are rife. In that country, probably no more than 10% of live births are registered. Without records, and often without government help, the UN has to use disparate tallies from peacekeepers, medical workers and NGOs.

In a 2005 report that enraged Sudan's government, the charity Médecins Sans Frontières listed almost 500 cases of rape against women, children and men through clinics in south and west Darfur over less than five months. In eastern Congo, the UN says that between June 2007 and June 2008, in Ituri province alone, 6,766 cases of rape were reported, with 43% involving children; and for each rape reported, it is likely that ten to 20 go unreported.

The human, social and economic results are dire. Sexual violence by marauding armies or militias can—as is often intended—wreck or uproot communities, with shame turning victims into outcasts. Ex-child soldiers returning to their home region, often with scant education or skills, may grow up into sadistic adults.

Doctors and counsellors are often overwhelmed. In Bosnia, tens of thousands of women were raped; in eastern Congo in recent years some 80% of fistula cases reported in women are thought to be the result of such crimes. High numbers of similar cases were reported from Burundi, Chad, Congo, Sierra Leone and Liberia, according to the Geneva-based Centre for the Democratic Control of Armed Forces. An estimated 70% of Rwanda's rape survivors were infected with HIV.

At least the climate of impunity is changing. The UN-backed special courts for Rwanda and ex-Yugoslavia were the first to take testimony and bring charges based on the use of rape as a method of war. A similar body for Sierra Leone won the first conviction for sex slavery (and another over the use of child soldiers).

Now the International Criminal Court at The Hague has stepped in. Thomas Lubanga, a Congolese ex-warlord, is on trial (the court's first) for recruiting children under 15 to fight. A former Congolese vice-president, Jean-Pierre Bemba, will hear soon whether he will be tried for war crimes stemming from rapes in the CAR.

Accusations of genocide against Sudan's President Omar al-Bashir (which may soon lead to an arrest warrant) are based in part on evidence suggesting a systematic campaign of racially-motivated rape by Arab *janjaweed* militias, in the pay of his government, against black fellow Muslims in south and west Darfur. Such charges appear to be borne out by video clips released by the British-based Aegis Trust: a government soldier saying he was forced to rape at gunpoint by an officer; other perpetrators saying such acts were meant to make babies of a different race.

The UN Security Council has weighed in too. Resolution 1820, adopted last year after a tussle, affirms

that sexual violence as a weapon of war affects international peace and security, and could trigger sanctions; an earlier resolution (1612) aimed to protect children in war zones. Both tell the UN secretary-general to report more often on the fate of women and children in wars.

He will find plenty to say. In Colombia at least 8,000 children are being used by armed groups of left and right. Meanwhile, the UN's children's fund, Unicef, frets that efforts to demobilise child soldiers often miss abused girls under pressure to stay with their abductors. The agency is lobbying governments to sign a protocol attached in 2002 to the Convention on the Rights of the Child, raising the age for military recruitment from 15 to 18; Unicef thinks there are 300,000 under-18s involved in more than 30 conflicts.

More victims are speaking out bravely. In eastern Congo, where rape is a weapon of choice for several militias, the *New York Times* recently reported that some women have started telling their stories in open forums; meanwhile, mobile courts are helping victims in remote forests to seek redress. A Congolese doctor, Denis Mukwege, has won international acclaim for helping rape victims. Part of the case against Mr Lubanga was based on video accounts by child soldiers of the horrors they saw. These were collected by a group called Ajedi-ka, shown first in Congo and then distributed by Witness, a human-rights group based in New York.

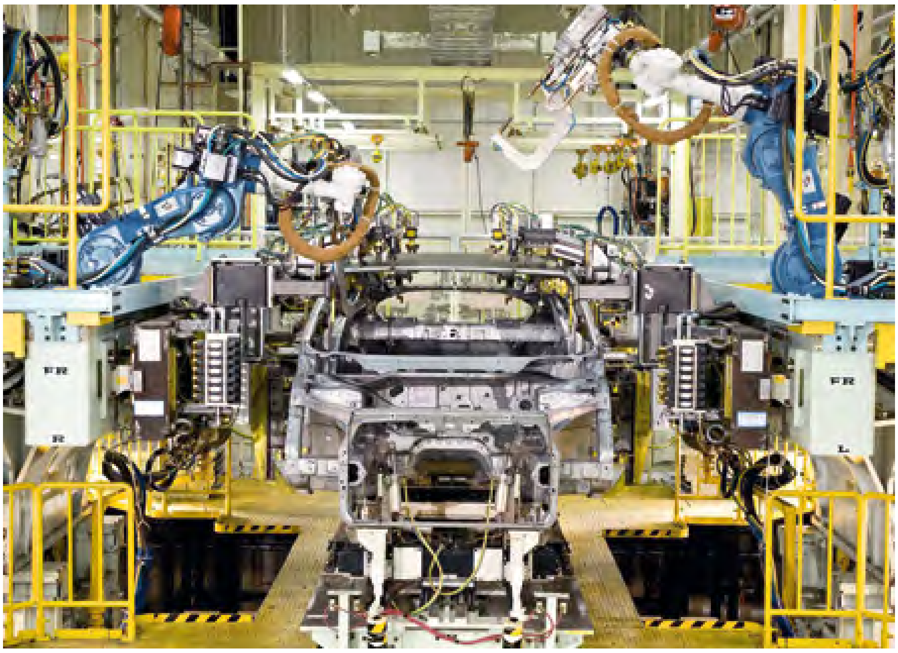
Liberia's women helped see off one tormentor: protests organised by Christian and Muslim women helped push their president, Charles Taylor, into exile in 2003. He is now on trial at The Hague on 11 counts of war crimes, crimes against humanity and other butchery. If Sudan's Mr Bashir ever appears in court, he may find that war victims in his country are equally eloquent and brave.

The American car industry

In pieces

Feb 19th 2009
From The Economist print edition

Eyevine



General Motors and Chrysler say they need more help. So do their suppliers

FROM the moment in December that the outgoing Bush administration reluctantly threw a $17.4 billion lifeline to General Motors and Chrysler, it was always likely that one way or another the government would have to provide a lot more money. So it has proved.

On February 17th the two struggling carmakers submitted recovery plans to the Treasury Department, as required under the terms of the emergency-loan deal. GM said that it would need at least another $16.6 billion, in addition to the $13.4 billion it has already received, to become smaller, leaner and, it hopes, profitable. It is also seeking $6 billion from other governments to prop up its generally more successful overseas operations. To stay in business, Chrysler asked for $5 billion on top of its existing $4 billion loan.

Both firms insisted that if they did not get the money, bankruptcy would end up costing the taxpayer a great deal more. GM reckoned the government might have to stump up $86 billion to finance its passage through Chapter 11, and Chrysler put the cost of "debtor-in-possession" financing of an orderly wind down of its operations at $24 billion. Most of that money would have to come from the government.

The numbers, though big, were foreseen. The money advanced by President George Bush was only a down-payment designed to see the companies through the first quarter, while his successor decided what to do. Since then, the light-vehicle market has deteriorated further. New-car registrations in America fell by 37.1% year-on-year in January. That equates to an annual market of just 9.5m vehicles, compared with 13.2m in 2008 and 16.1m in 2007. GM is now projecting a market of 10.5m this year, rather than the 12m it had thought was a cautious assumption in December. The company has decided to shut 14 factories in America instead of the nine it had announced. It will eliminate nearly 2,000 dealers and cut 47,000 employees from its payroll, 20,000 of them in America. The Hummer, Saturn and Saab brands are all up for sale or closure. GM thinks it can break even next year, provided the market recovers to 12.5m vehicles or so.

Chrysler attempted, somewhat unconvincingly, to show how it might survive either in a shrunken form as an independent company or as a more successful and global outfit if a proposed alliance with Fiat goes ahead. The Italian carmaker has offered to supply Chrysler with fuel-efficient engines and small-car

platforms in exchange for a 35% stake. In that case Chrysler expects, optimistically, to reduce its capacity by only 100,000 vehicles a year.

Both firms (and Ford) also announced tentative agreements with the United Auto Workers union to bring labour costs fully into line with those at the American factories of Asian and European carmakers. But they have been less successful in meeting two of the government's other conditions for funding. The UAW is unwilling to accept that half the payments into a union-run trust to cover retired workers' health care should be in company stock. GM is also struggling to unite its bondholders in an agreement to convert two-thirds of its $28 billion debt into equity.

One problem may well have been an absence of sustained government pressure on the negotiators. Only the day before GM and Chrysler were due to present their plans did the administration finally get around to setting up a presidential task-force that will assess both the restructuring efforts of the two companies and the plight of the rest of the American automotive industry. The panel, to be chaired by the treasury secretary, Tim Geithner, and the director of the National Economic Council, Larry Summers, includes Ron Bloom, a former banker and consultant to the United Steelworkers, who played a big part in restructuring the American steel industry.

The task-force faces an unenviable task. In theory, if it is unimpressed by what GM and Chrysler have come up with by March 31st, when the carmakers have to show that their plans are bearing fruit, it could demand immediate repayment of the loans the government has already granted. Given the noises coming from the White House, that is highly unlikely. But the task-force still faces three big, urgent and inextricably related questions.

The first is whether GM really can achieve the required degree of restructuring without entering into some form of managed bankruptcy. The second is whether Chrysler—even with Fiat's assistance—has a future as an independent company. If not, would it make more sense to grasp the nettle now by selling those assets, such as the Jeep brand, that still have some value? The third is what help should be given to the car-parts industry, which receives far less attention than its famous customers, but which is facing acute problems of its own.

The plight of the parts-makers demonstrates both the urgency and the complexity of the situation. Their trade organisation, the Motor and Equipment Manufacturers Association (MEMA), wrote to Mr Geithner on February 13th warning him that the entire industry, which is the largest manufacturing employer in the country, was facing "breakdown". In the 18 months to June 2008 the industry's employment fell from 783,000 to 653,000, since when the rate of job losses and bankruptcies has accelerated.

Although the suppliers are heavily exposed to the difficulties of the Detroit Three, most of them also sell parts to the Asian and European manufacturers in America (see table). Given the extreme interdependency of the supply chain and the degree of specialisation within it, the failure of even one or two small firms can lead to stoppages on vehicle-assembly lines.

Part and parcel

% of suppliers selling parts to:

	GM	Ford	Chrysler
that also supply:			
Chrysler	56	64	–
Ford	51	–	54
GM	–	70	66
Asian manufacturers	58	65	59
European manufacturers	37	46	44

Source: CSM Worldwide

The collapse in new-vehicle demand has traumatised parts-makers. They have seen their cashflow fall by half or more during the first quarter, as carmakers have scrambled to cut production, in many cases entirely shutting factories for weeks and months. MEMA's surveys suggest that a third of the supply base is already in financial distress, and another third expects to fall into that state before the end of the quarter. With inventories finally thinning, the carmakers are now starting to ramp up production, albeit at a much reduced rate. But parts-makers, which typically get paid only after 55 days, must somehow find the cash to supply their customers when no one will lend to them and no payments can be expected before late April.

Parts suppliers used to be able to borrow against payments owing from the Detroit Three, but now cannot find any lenders willing to bear that risk. So they are asking Mr Geithner to guarantee the debt, and to oblige GM and Chrysler, as a condition of their federal loans, to pay them within ten days rather than the usual 55.

But it is unlikely that even these measures would be enough to stave off mass bankruptcies were the task-force to allow GM to go into Chapter 11, which in turn would jeopardise the ability of the carmakers so far not seeking bail-outs—Ford and the foreign transplants—to keep their factories open.

President Obama has said that the final decisions about the future of America’s automotive industry will rest with him. It is doubtful whether any of the choices his task-force presents him with will be either cheap or palatable.

German manufacturing

A thousand cries of pain

Feb 19th 2009 | WOLFSBURG
From The Economist print edition

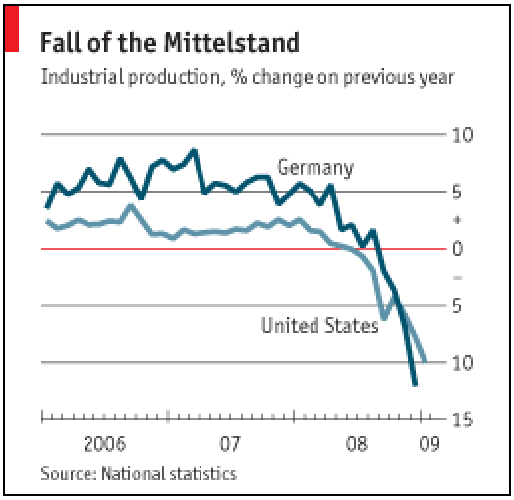
The fabled Mittelstand is feeling the pinch more than most

TWO gleaming towers of glass rise above the wooded hills next to a Volkswagen factory in Wolfsburg, Germany. They are garages, as sleek as the vehicles they store. Automated lifts whizz cars about before sending them off to a cathedral-like hall to be collected by reverent buyers. But this delivery centre, where in normal times a new car would be handed over almost every minute, is almost deserted. Sparks may still fly on the assembly line and the two towers, each holding 400 cars, are stacked to the brim, but customers are hard to find.

VW's lament is also Germany's. A ferociously efficient manufacturing and exporting economy is grinding to a halt, as demand across the world melts away. Yet until quite recently the notion that Germany would be beset by the global downturn seemed unthinkable. For this was a country that has not only prudently managed its finances—both public and private—but is also one that has conducted painful economic reforms over the past decade. Both, it was thought, would leave it well placed to weather the global economic storm.

Two decades ago Germany's unit labour costs, for instance, were some 12% above the euro-zone average, earning it the epithet of the "sick man of Europe". Today, after a decade of wage restraint and labour-market reforms, they are some 13% below the average. And until recently, at any rate, German firms did not seem to be having as much trouble borrowing as their British, Italian or Spanish counterparts.

But in recent weeks a rash of new data has pointed to a sharp downturn in orders and exports that has shaken German complacency. Industrial production is falling more steeply than in America (see chart). The number of full-time employees getting government wage subsidies to compensate for working shorter hours has now surged to more than a quarter of a million, from just 16,000 a year ago. Enbw, Germany's third-largest utility, reckons that, because of falling industrial demand, it is generating three terawatt-hours less electricity a month—which is the equivalent of removing a medium-sized city from the grid.



Germany is not alone in suffering a manufacturing slump. Japanese industrial production has sunk to a level not seen in two decades. And in Britain manufacturers are at their gloomiest since 1980. Yet there is much to suggest that Germany will fare worse than most in the slump and that its pain will be felt most acutely by its famed *Mittelstand*, the thousands of family-owned small and medium-sized firms that are the backbone of its economy.

Germany's status as workshop of the world makes it uniquely vulnerable to the downturn. For six years it has been the world's largest exporter. More than a fifth of economic output and a quarter of employment are based on exports, making it particularly vulnerable to a fall in global growth and trade. Deutsche Bank reckons that German exports will fall by about 8% this year, their steepest drop in 15 years or so. *Mittelstand* firms, which account for some 40% of all manufactured exports, seem especially vulnerable to the downturn. Many specialise in making complex and valuable equipment for factories, such as cigarette-rolling machines or printing presses. That has helped them dominate their niches, with global market shares of up to 90%. Yet these are also the products whose orders are the first to be cancelled when economies slow and companies trim investment. Demand for German machine-tools, for instance, slumped by 40% in December from a year earlier.

It does not help that Germany's small and medium-sized manufacturing firms are finding themselves

chronically short of capital. Equity provides less than 15% of small and midsized firms' funding, compared with at least twice that in most other big economies. The *Mittelstand*'s reliance on loans from local banks has long been seen as a virtue. The bankers, it was said, would take a longer view and be more understanding of downturns than the fickle stock- or debt-markets sought out by firms elsewhere.

That does not seem true today. The *Mittelstand*'s trade association complains that even the friendliest savings banks are tightening their purse strings as a result of the Basel 2 accords on bank capital, which compel them to hold extra reserves against loans to small firms. Firms with so little equity have almost no ability to absorb temporary downturns or shocks, says Volker Beissenhirtz, an insolvency expert at Schultze & Braun, a German law firm.

Even amid the gloom, however, are some signs of hope. The benefits of some elements of Germany's stimulus programme are already being felt. A rebate offered to buyers of new cars has led to a run on dealers. Carmakers that only weeks ago cut shifts and working hours are now thought to be considering recalling workers. And having already made painful reforms, Germany is well placed to benefit from a rebound in the world economy. "Germany lagged the rest of Europe coming out of the last recession," says Jörg Krämer, chief economist at Commerzbank. "This time we'll get the benefit of our past measures and there won't be any talk of us being the sick man of Europe."

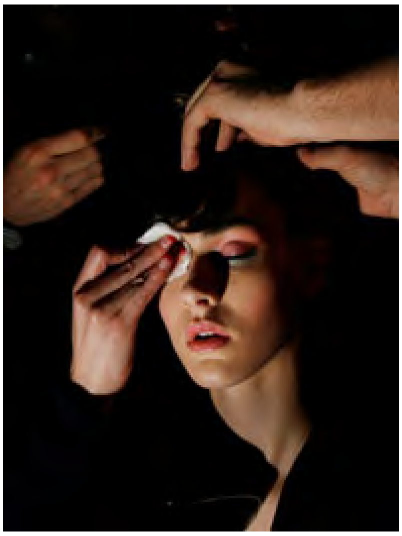
Fashion

A new look

Feb 19th 2009 | NEW YORK
From The Economist print edition

Creative destruction meets haute couture

AP



Cold-comfort cream

AMERICA'S elite designers gathered in New York this week to show off their autumn collections. Threadbare sales had prompted some onlookers to question whether all the exhibitors would still be around come autumn. The industry's striking new look at Fashion Week gives a hint of the sort of makeover it will need to survive.

This season many designers chose to abandon the catwalk, the very symbol of fashion. With the cost of a 20-minute show in the event organiser's tents easily exceeding $100,000, some designers, such as Vera Wang and Betsey Johnson, decided to cut costs by holding smaller spectaculars at their own showrooms. Others opted for even thriftier "presentations", where models were hired to stand on podiums like mannequins for a few hours, or to mingle with the ordinary mortals in the crowd.

The collections were also smaller, a sign of the reduced demand for luxury clothing. Department stores have already said they will curb buying, reining in designers who used to make the same dress in a dozen hues.

In a daring display, the fashionistas, who normally trade in exclusivity, have opened their hallowed halls to mass-market brands. Mattel, which makes Barbie dolls, put on a fashion show to celebrate the leggy blonde's 50th birthday. Guests received dolls of their own to take away. McDonald's paid an undisclosed amount to be the official coffee-purveyor, in an attempt to persuade designers that they do not have to drink designer coffee. And QVC, a television and internet shopping company, put on a runway show of its own, with all items costing less than $120.

Some wonder whether the industry's calendar of seasonal shows in several different cities round the world may itself go out of fashion. One firm, Halston, recently released its autumn collection through a music video. Others are also likely to pursue digital means to reach a broader audience. Catherine Malandrino, a popular French designer, has spent the past three months reworking her website to make it more "human and interactive". Fashion, she points out, was historically sold through intimate salons. She wants to re-establish that accessibility—and the internet allows her, and others, to do it cheaply.

Starbucks

Just add water

Feb 19th 2009
From The Economist print edition

The ailing giant turns to instant coffee for a pick-me-up

Illustration by David Simonds

NO ONE can accuse Howard Schultz of inaction since he returned as chief executive of Starbucks, the firm he built into a multinational only to watch it stumble under his successor. Barely a month has gone by over the past year without the firm announcing some new initiative or other. The latest came on February 17th in New York, when Mr Schultz unveiled Via, an instant coffee which, he claims, tastes just as good as Java brewed in the shop by one of the firm's baristas.

Mr Schultz hopes to win a share of the $17 billion or so the world spends on instant coffee—a product which, he sniffs, has not improved in decades. Starbucks itself has spent 20 years pursuing the holy grail of an instant coffee that tastes as good as the fresh stuff. Don Valencia, the firm's first head of research and development, who created the blended and frozen frappuccino drinks that earn Starbucks $2 billion a year, could never find a way to scale up an instant formula he had developed at home. When Mr Schultz returned as chief executive, he noticed that there had been some technological advances, allowing finer grinding, for example. So he asked the R&D team to repeat the recently deceased Valencia's experiments, and found that "we had broken the code". The name Via is a hat-tip to Valencia—though during development it was known as Jaws (just add water, stir).

Starbucks says it has patents that should prevent competitors from quickly replicating Via, which will go on sale in some American stores next month. The opportunity may, however, be biggest in other countries: in Britain over 80% of coffee sold is instant, compared with just 10% in America.

Assuming Starbucks drinkers decide that Via tastes good, the company will have to get the price right. At first, it will come in packets of 12 or 3 individual servings, for 83 and 98 cents a cup respectively. That is much more than other instants, but much less than a cup of coffee at one of Starbucks' stores. The risk is that the firm's existing customers may abandon counter service and start making their own cup of instant.

That would encourage them to visit Starbucks less often, a trend that is already gathering pace with the recession. The nickname "Fourbucks" has not helped at a time when consumers have become cost-conscious. For the first time in Starbucks' history, same-store sales have fallen.

Mr Schultz has had to accelerate the store-closure programme that he had started in order to correct the over-expansion which prompted his return to the helm. To keep customers coming to remaining outlets, he might experiment with discounts such as cheap "combination meals" of a drink and food. He also wants a visit to a Starbucks shop to be a "uniquely uplifting experience". Improving the smell in stores by changing the cheese used in breakfast sandwiches was a start. But ensuring that staff are enthusiastic will be especially difficult when jobs are disappearing. Mr Schultz remains hostile to unions, but has decided to maintain the firm's popular health benefits, while cutting his own pay.

Will all this be enough? So far, investors seem sceptical: Starbucks' share price remains barely a quarter of its all-time high in 2006.

Liberty Media gets Sirius

Feb 19th 2009
From The Economist print edition

The last-minute rescue of Sirius XM is not just about money

WITH $172m of debt due on February 17th and no cash to pay it, Mel Karmazin, the boss of Sirius XM, America's sole satellite-radio operator, faced an unpalatable choice: declare bankruptcy or be taken over by an old adversary, Charles Ergen of DISH Network, a satellite-television provider. However, at the last minute, Mr Karmazin rustled up another deal, which grants his heavily indebted firm a reprieve. John Malone's Liberty Media, which controls DirecTV, Mr Ergen's arch-rival in the satellite-television business, will lend Sirius XM up to $530m in several stages, after which it will receive a 40% stake. But Sirius XM is not just another firm caught out by the near-impossibility of rolling over big debts in the midst of the credit crunch: it faces even bigger worries.

Mr Malone, who amassed a fortune by building and selling a cable-television empire, is more of a dealmaker than a technology visionary. Liberty plays down any possible synergies between its television interests and Sirius XM's radio channels. Instead, it portrays the deal as essentially a passive investment that offers a good return. It certainly appears so: Liberty will earn an enticing 15% on most of the money it is lending. If Sirius XM can roll over the rest of its debts and gain enough subscribers to start generating cash, Liberty should get its money back with handsome interest plus, as a bonus, a big stake in a going concern. If things go wrong and Sirius XM collapses, Mr Malone will end up fighting to get his money back alongside other creditors, including Mr Ergen, who has been buying Sirius XM's debt.

There are reasons to worry about Sirius XM's business model, says Tom Eagan of Collins Stewart, a stockbroker. It is under threat from both the recession and increased competition. Among customers who bought their satellite receivers in a shop (which is about half the total of 19m), the numbers cancelling their subscriptions have recently overtaken the numbers signing up. Most of the remaining subscribers bought new cars that came with satellite receivers installed. Their numbers were still growing when Sirius XM put out its most recent figures, for the third quarter of 2008. Since then, however, the slump in car sales has deepened. New-car buyers usually get a free trial of Sirius XM's stations for up to a year, after which only about half decide to keep subscribing.

The main selling-points of satellite radio are its crystal-clear sound, near-universal coverage and a broad choice of advertising-free content, from sports to chat to music. But between them, smartphones such as the iPhone and digital terrestrial radio, which is spreading across America, are eating into Sirius XM's advantages.

That said, the firm (formed from a merger of two rivals, Sirius and XM, last year) has proved adept at offering content that people will pay for. Subscriptions soared when it signed up Howard Stern, a "shock jock", and it has created hit shows fronted by such celebrities as Bob Dylan and Martha Stewart. Although doubts remain about Sirius XM's long-term prospects, it is already pulling in around $2.5 billion a year of revenues. And there may yet prove to be synergies from any future merger or venture with DirecTV, such as bidding jointly for rights to broadcast sports matches or to hire celebrity presenters. For someone with pockets as deep as Mr Malone's, it seems worth a punt.

Business in Hong Kong

Tycoons in the ascendant

Feb 19th 2009 | HONG KONG
From The Economist print edition

The territory's business elite makes its presence felt

WHAT will become of PCCW, owner of Hong Kong's biggest fixed-line phone company? On February 24th Kong Kong's High Court will begin to resolve that question, at a hearing regarding the shareholders' recent decision to approve a $4 billion buy-out led by Richard Li, the firm's boss.

AFP

Another satisfied shareholder

The hearing is tied to an investigation of the shareholder vote led by the local stockmarket regulator. Just before the vote took place, insurance agents attached to a former sister company of PCCW appear to have received small blocks of PCCW shares. No one seems to know how the agents got the shares, or how they voted. But the regulator has received several complaints about it all.

Under local law, a buy-out must be approved by more than half the shareholders that are not party to the acquisition. Leading up to the vote, the outcome had seemed in doubt. But in the end the deal sailed through, albeit with loud public protests.

Nothing will be final until the investigation is concluded. But if the deal closes, the firm plans to pay a special dividend that will cover the cost of buying out those who did not participate. Some shareholders, naturally, asked why Mr Li should be allowed to use their money to buy them out. The firm replies that its investment bankers approved the deal, and that it thinks the offer price was fair.

Mr Li is a shrewd judge of prices. In 2000 PCCW, then a fledging internet firm, bought Hong Kong's former telephone monopoly, a favourite shareholding for local investors. It paid mainly with shares, just before the dotcom bust. They have since fallen by 95%.

Early on, Mr Li sold himself as a visionary leader who could combine every aspect of telecommunications—mobiles, fixed-line, broadband internet, cable television and so on—in a company that would eventually span Asia. In Hong Kong, PCCW does indeed have the biggest market share in most of those areas, and a modest presence in mobiles (which Mr Li jettisoned early on and is now attempting to rebuild). But Hong Kong is a small and saturated market, and PCCW has little presence elsewhere, despite Mr Li's ambitions. It is hard to see how taking the firm private will change that.

Meanwhile, Mr Li's father, Li Ka-shing, who is Hong Kong's richest man, has also been in the public eye of late. In a rare interview, he criticised the stock exchange's plans to extend the period before earnings announcements during which directors and managers cannot trade in their firms' shares. Other families, controlling more than 200 local firms, had also decried the exchange's move.

On February 12th the stock exchange cracked and reversed itself. Share prices duly fell. Call it the tycoons' discount.

Hotels

Outsourcing as you sleep

Feb 19th 2009
From The Economist print edition

Reservations are plunging, but virtual hotel chains should escape the worst

YOU book a room on the website of a famous international hotel chain. As you arrive to check in, its reassuring brand name is above the door. Its logo is everywhere: on the staff uniforms, the stationery, the carpets. But the hotel is owned by someone else—often an individual or an investment fund—who has taken out a franchise on the brand. The owner may also be delegating the running of the hotel, either to the company that owns the brand or to another management firm altogether. The bricks-and-mortar may be leased from a property firm. In some cases, yet another company may be supplying most of the staff, and an outside caterer may run the restaurants. Welcome to the virtual hotel.

IHG

But who does she work for?

The franchising of hotels, like the franchising of fast-food restaurants, is half a century old. But it has received a further boost in the past few years, as the biggest international hotel chains, under pressure from shareholders to return capital, have put even their poshest properties up for sale. They are now mainly franchisers and managers, rather than owners. In return for the fees they charge the hotels' owners, they provide a glossy brand name and a steady stream of bookings from their online reservations systems.

Among the keenest adopters of this virtual-hotel model, also called "asset-light", is InterContinental, a British-based firm which in addition to its eponymous hotel chain owns the Holiday Inn and Crowne Plaza brands. InterContinental was formed from a demerger in 2003, just as the business emerged from the dotcom bust. Even then, it owned only around 200 of the 3,500 hotels that bore its brands. But during the recent boom it sold most of the remainder, while expanding worldwide through new franchising and management contracts with hotel developers. It now owns just 16 of the 4,186 hotels in its system.

The hotel business was doing fine until Lehman Brothers' collapse in September. Since then bookings have drooped. InterContinental said on February 17th that its "revpar"—revenue per available room, the industry's benchmark—fell 6.5% in the fourth quarter. Marriott and Wyndham, two American rivals, have reported similar falls; Starwood, another American chain, says revpar has dropped by 12.1%. All are gloomy about this year.

However, the brunt of the recession will be borne by the hotels' owners rather than the chains that manage and franchise them. Simon Mezzanotte of Société Générale, a bank, explains that if revpar falls 1% at a hotel, its owner typically suffers a 5% profits fall. But the management fees (which are usually linked to a mix of the hotel's revenues and profits) fall by 3%; and franchise fees (which are usually linked

only to revenues) fall by only 1%.

So chains that have adopted the virtual-hotel model should suffer less in the recession. InterContinental should do better than its peers since around 75% of the rooms in its system are in franchised hotels, compared with 39% of Starwood's. Starwood wants to continue virtualising its hotel system: its chief executive, Fritz van Paaschen, says franchise and management fees were 53% of total revenues last year, up from 18% five years earlier, and he wants them eventually to rise to 80%.

Many hotel owners, having taken on most of the risk, will collapse into bankruptcy during the recession. Even so, says Stephen Broome, a consultant at PricewaterhouseCoopers, the big hotel chains will have few worries: when banks take possession of a hotel from a bankrupt owner they usually keep it open, as hotels lose up to half of their resale value once they are closed. Thus the hotel chains will in most cases continue earning their franchise and management fees. In some cases bankruptcies will be a source of new business: Hostmark, an American hotel-management chain, says that last year it was brought in to run five hotels by lenders who took possession after the previous owners collapsed.

Although they have offloaded much of the risk posed by the recession, the big hotel chains have exposed themselves to two new dangers. One is that investors are now assessing them not just on their revenues, but also on their "pipeline" of future franchises and management contracts, mostly from hotels under construction. Leslie McGibbon of InterContinental says his firm is still signing up new hotels at a rate of two a day, despite the downturn. But beset by falling bookings and scarce financing for hotel construction, the firm's impressive pipeline, which benefits its share price, is likely to be squeezed. The other risk is that, when recovery eventually comes, most of the gains will go to the hotel owners—at least, those that survive.

Face value

In a deep hole

Feb 19th 2009
From The Economist print edition

Tom Albanese has turned to a Chinese firm to dig Rio Tinto out of trouble

Bloomberg News

EVEN as a young man, Tom Albanese gathered that there was much more to mining than digging big holes in the ground. Shortly after arriving at the University of Alaska at Fairbanks, he persuaded the authorities to create a new degree course for him combining geology, the subject of a true mining man, with economics, an area of study that geologists often regard with bafflement and suspicion. But he had wisely noted that the business of mining is as much about judicious dealmaking when the commodity cycle is in your favour as it is about digging riches directly from the earth—and he wanted to be prepared.

Since becoming chief executive of Rio Tinto, one of the giants of the mining industry, in May 2007, Mr Albanese has grappled with three big deals, which have come to dominate both Rio's fortunes and his own. In the first, just a few months into his tenure, he outbid Alcoa, an American aluminium firm, to secure Alcan, a Canadian rival, for $38 billion. A few months later, he spurned a second deal, a takeover bid from rival BHP Billiton. Both those decisions now look like mistakes, in the light of the subsequent collapse in commodities prices. So Mr Albanese has responded by concocting a third deal, with Chinalco, a largely state-owned Chinese aluminium firm. But many of Rio's shareholders have already lost faith in his dealmaking prowess.

Mr Albanese, under pressure from all sides, "fully accepts that values have changed" since Rio bought Alcan. The purchase, which saddled Rio with $40 billion in debt, was based on the premise that the commodities cycle was still some distance from a downward turn. But in the final quarter of 2008 the slowdown in China and slump elsewhere sent metal prices into a tailspin. Some $9 billion of Rio's debts fall due this year, and $10 billion in 2010. But the firm is not generating enough revenue to pay them off, and has few refinancing options amid the credit crunch.

Mr Albanese's decision to rebuff BHP Billiton's advances has also tarnished his dealmaking credentials. He expended much time and effort in 2008 marshalling arguments to see the bid off, believing that it seriously undervalued Rio and that his company was better alone. But now Rio's stockmarket value hovers around $35 billion, far below the $190 billion price implied by BHP's all-share offer at one point during the takeover battle.

Mr Albanese was not the only boss of a big mining firm to misread the robustness of China's rampant growth, which had driven a six-year boom in commodity prices and made mining unimaginably profitable. But he is the only one to have turned to China for a bail-out. The hope is that this time round

China will prove easier to read.

Chinalco has come to Rio’s defence once before. The Chinese firm (with a little help from Alcoa) paid $14 billion for a 9% stake in Mr Albanese’s company in February 2008 at the height of the takeover battle with BHP. Chinalco’s stakebuilding was widely interpreted at the time as an effort to block a merger that China feared would lead to two companies (Rio/BHP and Brazil’s Vale) dominating the seaborne trade in iron ore. That, in turn, would have conferred upon them unwelcome pricing power over a commodity that is particularly crucial to China’s economy.

In the end, BHP dropped its bid, citing Rio’s debilitating debts. Now Mr Albanese is turning to Chinalco to help him with those, too. The Chinese firm will pay $12.3 billion for stakes of up to 50% in nine of Rio’s mines and $7.2 billion for convertible bonds that would give it the right to raise its stake in Rio to 18%.

The deal digs Mr Albanese out of a hole the size of Tom Price, the huge iron-ore complex in the Pilbara region of Western Australia in which Chinalco stands to take a stake. But it has met with a blast of criticism, not least from other investors who had hoped to take part in fund-raising. Mr Albanese reckons on two difficult years before commodity prices pick up again. He believes a rights issue could have raised only around $10 billion—not enough to see the firm through. But others disagree: misgivings about the deal seem to have prompted the resignation of Jim Leng, the company’s chairman-designate.

Some of the furore can be dismissed as unwarranted sinophobia. Mr Albanese points out that these types of joint ventures, even with potential customers, are not uncommon in mining. And many analysts agree that Mr Albanese has wrested a decent price for the slices of his assets in a depressed market. But some critics contend that some of these mines are ripe for the sort of expansion that could greatly boost their value when times are less tough. If so, it seems that Chinalco, after losing heavily on its first investment in Rio, has struck a better deal this time.

A Chinese puzzle

Should Mr Albanese worry that Rio’s biggest shareholder by far could be the Chinese government, which also owns stakes in some of its biggest customers? He is keen to point out that Chinalco is “independent and commercial”. Australian regulators, nervous about China’s influence over such prime assets, are closely scrutinising that claim. Mr Albanese vaunts the strategic value of Chinalco as a partner with its expertise in and access to China’s markets and its ability to raise further Chinese funds.

The nature of the relations between Chinalco and China’s government is opaque. But Mr Albanese is confident that governance rules will preclude Chinalco’s directors from taking part in boardroom discussions where there is potential conflict between China’s interests (keeping commodity prices low) and those of Rio’s other shareholders (pushing prices higher). Moreover wealthy China is sure to make more big foreign investments, so it should be keen to prove it can be a responsible partner.

Shareholders will get the chance to vote on Mr Albanese’s latest bargain around the middle of the year, if regulators give it the go-ahead. If they balk, or the deal sours, Mr Albanese’s deal-making days will be numbered.

Time to change the act

Feb 19th 2009 | DONGGUAN
From The Economist print edition

Business in China, like business everywhere else, is being walloped by the global crisis. The slowdown is also exposing some deeper flaws

Illustration by Claudio Munoz

A SMALL stretch of land, a two-hour drive from end to end, reveals much about the economic transformation of a vast country. This slice of southern China runs from Guangzhou, the old treaty port reserved for foreigners before Mao expelled them, to Shenzhen, the city established after Mao's death as an experiment in private enterprise. Over the past decade it has become one of the world's fastest-whirring economic engines—a global hub in the manufacture of clothing, shoes and electronics—serviced by tens of millions of migrant workers.

Now the region is undergoing an equally remarkable contraction. In the past year thousands of factories, perhaps one-third to one-half of the total, have closed. Reliable statistics are hard to come by, not least because many factories operate in a legal netherworld, but the severity of the slump is plain. The flow of migrants has gone into reverse. Some of the newly unemployed have stuck around (and a few have started a new industry: street crime). The lucky ones have found work at factories that moved inland, although at lower pay.

On the road through Dongguan, a sprawling industrial city roughly halfway between Guangzhou and Shenzhen, building after building—residential as well as industrial—displays red banners advertising its availability. Local agents say there is no interest from buyers. A lack of demand for whatever a factory might make is part of the explanation. So is concern about the quality of properties for sale: a lot of factories were put up in a hurry and have been maintained poorly if at all. And so is the nebulousness of Chinese property laws. Purchasers cannot be sure that what they buy they will truly own.

Oh, for yesterday's problems

The rapid collapse of economic activity around Dongguan indicates that China's private companies are being subjected to the same battering as their counterparts in many other countries. Yet it also raises questions about the long-term survival of many of these companies. They have been among the most dynamic components of China's fast rise towards prosperity. Their turmoil may be transient. Then again,

there are also worries that it is in fact tied to profound flaws in the Chinese economy.

Six months ago Chinese manufacturers were being pounded by increases in all manner of costs, from wages and the prices of materials and energy to interest rates and taxes. Just about every type of skilled labour was in short supply. Annual results for 2008, due to be released in the next couple of months, will show that these forces did much to hold back Chinese business for a large part of the year.

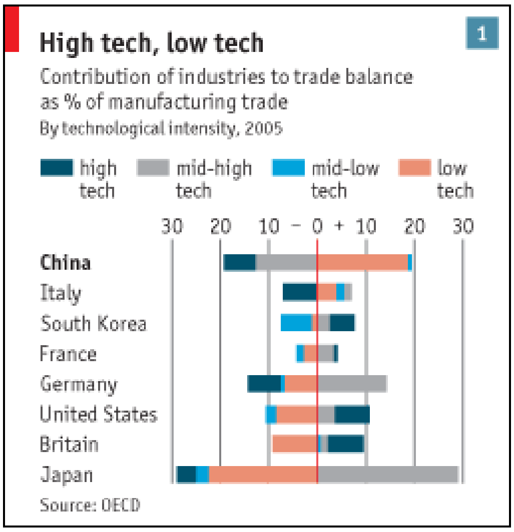
Now those manufacturers are taking a different sort of pounding: a dramatic falling-away of orders. December's official industrial-production data, for what they are worth, showed a marked drop in annual growth; January's are delayed (see article). Exports, on which the figures are more reliable, were 17.5% lower in January than a year before. Imports were down by 43.1%.

The slowing economy has sent all those costs in the other direction. It has brought the prices of materials and energy down sharply and slackened the labour market. After years of steadily pushing up interest rates and increasing banks' capital requirements, the financial authorities in Beijing began to cut both in September, and lending has been vocally encouraged.

Fearful of the social consequences of widespread unemployment, both local and national governments have backtracked on policies put in place between 2006 and 2008 that raised private companies' costs. Exporters' tax rebates have been restored, for example; and new laws on wages, work rules and benefits that added costs a year ago are turning out to be more flexible than they at first appeared. Around Dongguan, local officials no longer seem bothered about pushing the region towards higher-value-added products. Makers of labour-intensive goods, such as apparel and toys, find that they are no longer under pressure to move away. A strike that the municipal government would have all but encouraged for much of 2008, it would now help to settle. None of this has come anywhere near offsetting the decline in orders. Worse, the malaise may go far deeper than the short-term effects of a slump in demand.

A footloose business

Much of the remarkable success of Chinese business has been based on low-margin, low-technology activities. Broadly speaking, China is a net exporter of goods with a low technology content and a net importer of more sophisticated wares. In richer countries, not surprisingly, the reverse is usual (see chart 1).



Many Chinese businesses have been built on using cheap labour to produce cheap, commoditised goods such as clothes and shoes for export. Lots of others produce higher-grade stuff, such as electronics goods or branded sportswear for Western companies. The trouble is that other countries can also do this, sometimes more cheaply.

Granted, China has plenty of important companies which do not need to worry about their business disappearing to other emerging economies. More than 30 of the 100 firms anointed by the Boston Consulting Group in January because they are "contending for global leadership" are Chinese. No other country can boast so many. However, almost all of these are owned at least in part by the government and benefit from protective barriers in their home market. China Mobile, for example, is the world's largest mobile operator, but its competition is limited, by ministerial decree, to just a few other domestic rivals. The same goes for steel, aluminium, energy, finance and a host of other areas that the government deems "strategic".

A more durable model for less privileged companies would involve more higher-margin activities, based on innovation and higher quality, with their home-grown brands to the fore. So far, however, Chinese companies have been plagued by an actual or perceived lack of quality. Only a few have built respected brands. The underlying causes of this are a weak system of property rights (including intellectual-property rights) and a financial system skewed in favour of big, state-controlled companies. They will not be easy to fix.

The downturn has shown much of Chinese business to be remarkably footloose. It is as if the companies

that died simply evaporated without leaving a tear or a trace. There is more to this than the eradication of excess capacity or the shift of production inland. Buyers in Hong Kong who a year ago drove over the border to buy clothing in southern China now take flights to Dhaka in Bangladesh. Nike will produce more trainers (sneakers) in Vietnam this year than in China, its leading source for 15 years.

In 1988 a small, secretive, Taiwanese plastics manufacturer named Hon Hai opened a factory in Shenzhen that has since grown to the size of a city, with more than a quarter of a million employees. Little of what its Chinese subsidiary, Foxconn, produces is directly disclosed by the company but it is broadly believed to include iPods, Nintendo and Microsoft games consoles and laptops, either in whole or part, for most leading brands.

Because of the sheer number of people it employs, Hon Hai's every move generates huge interest in local newspapers, although the firm itself says little. In 2007, presumably for much the same reason that it moved to China 20 years ago, it opened a facility in Vietnam which is said to be undergoing a large expansion. Last summer the Taiwanese press was abuzz about production moving back home. Now reports from Taiwan say that the Shenzhen workforce will be cut from 260,000 to 100,000 and that there will be more jobs inland. Whatever the figure turns out to be, Hon Hai is a nimble transnational company, able to move production around as circumstances change. And it is not alone.

Admittedly, there are still good reasons to remain in China. Vietnam, Indonesia and other countries have only a finite ability to expand quickly without overloading their infrastructure or sparking wage inflation. China still has lots of cheap labour. Perhaps most important, it has a vast domestic market, much of which is protected from foreign producers. But as the frailty of the southern Chinese manufacturers demonstrates, these virtues have their limits.

Higher margins are often linked to higher quality. In a recent survey of 700 international business professionals by Interbrand, a consultancy, 80% of respondents cited low quality as an important barrier to the sale of Chinese products abroad. Two-thirds said "cheap" was the chief attribute of Chinese goods. Only 12% believed quality was improving.

Judged by the struggles Chinese companies have had operating abroad, such impressions are well founded. With rare exceptions, notably Lenovo, which purchased IBM's laptop business, and Haier, the maker of cheap, small refrigerators that furnish the rooms of numberless students, Chinese names have failed to make much of a dent. Where they have thrived is either in cost-conscious emerging markets or in cost-sensitive areas of developed markets defined by clear specifications and minimal innovation. The greatest examples of this have been ZTE and Huawei, makers of telecoms equipment.

The poor external reputation of China's products hurts not only Chinese companies but also Western firms known to be selling Chinese-made goods. Last year, in response to a series of scandals, buyers' complaints and lawsuits over Chinese toys, America passed laws requiring elaborate certification. This is costly for good manufacturers, but American toy distributors found themselves incapable of judging the safety of products they imported from China. Out of similar concerns, India has imposed restrictions on Chinese-made toy trains and cars, dolls and puzzles.

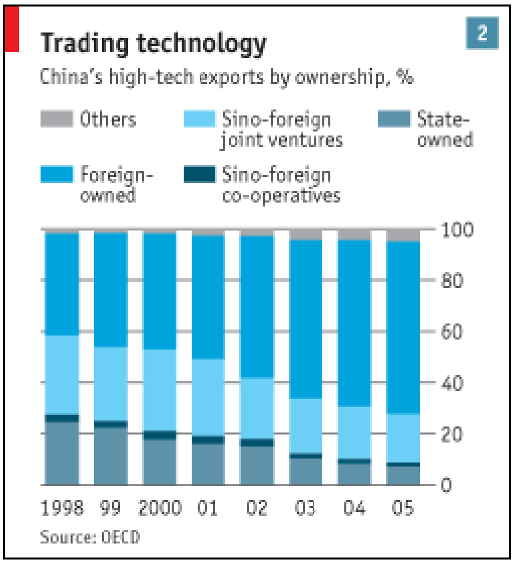
Why, then, have Chinese manufacturers not done more to improve the quality of their goods? The benign explanation is that China is undergoing the same problems as Japan once did, but in a litigious, consumer-centred age in which every flaw is magnified.

There is something to this, but Japan's national obsession with quality was apparent early in its post-war industrialisation, when it adopted the teachings of W. Edwards Deming, an American quality-control guru. Companies such as Honda crushed the British motorcycle industry by offering higher quality as well as lower prices; Sony and Panasonic did the same to American makers of radios and television sets. Almost all the successful companies began by producing at least some components for others (Sony still does) but were equally determined to carve out names for themselves by making distinctive products. To say these companies had long-term visions is an understatement. Konosuke Matsushita, the founder of Panasonic, drafted a 1,000-year corporate plan.

There is no equivalent in China yet. However, many Chinese companies are aware of the pervasive criticisms of their quality. Some big firms have begun employing Westerners with long experience in the best American and European facilities. The Chinese authorities are also awake to lack of quality, because of its deadly effects in the (heavily protected) domestic market, where it has been all too easy to succeed by being shoddy. Last year, after poisoned dairy products killed six children, the chairwoman of Sanlu, the most notable producer, was sentenced to life in prison. Two suppliers were condemned to death.

To be sure, lots of high-quality things are made in China, from sporting goods and MP3 players to luxury clothing. China has become the world's largest exporter of information and communications technology. Local markets and trade fairs are awash in aspiring brands. In transport alone, there are a dozen sizeable carmakers, 300 tyremakers, 1,000 bicycle-makers and several thousand scooter-makers, all hoping to make an impression. More than 3,500 watchmakers list their services on Alibaba, a sourcing website, as do 8,000 razor-makers. And myriad companies churn out the fake Gillettes and Rolexes sold on street corners.

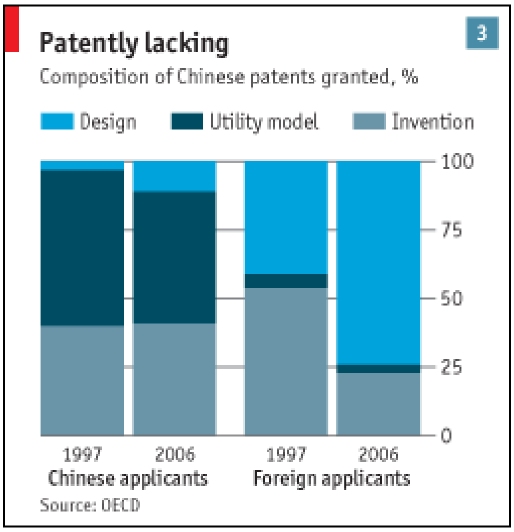
That very little of this effort has been converted into strong brands is something of a puzzle. Foreign companies account for most high-tech exports (see chart 2). The simplest explanation is that anonymity suits many Chinese companies. In Dongguan, Yue Yuen, a subsidiary of Pou Chen, a Taiwanese company with a similar model to Hon Hai's, produces sports shoes for leading Western names. Smaller firms make everything from tennis racquets to European luxury goods. Because wide publicity of the common origin would do those brands little good, the Westerners usually insist on contracts with clauses blocking disclosure.



Anonymity also spares Chinese companies from official and press scrutiny of labour conditions, which can be abysmal. But there are limits to this strategy, in as much as margins on undifferentiated production have proved low. Retaining customers means holding off competition from any country with lots of cheap labour, and, as southern China is finding out, businesses of this sort are vulnerable to being wiped out in a slump.

In Taiwan many of the companies that once were leaders in anonymous production have slowly developed high-quality products under their own names, notably Acer, Asus and HTC. The most glaring impediment to creating the same kind of operation in China is the country's weak intellectual-property protection. Why invest in design or innovation when the results can be knocked off by competitors? Aware of this barrier, the government has passed new laws and has been vocal in supporting greater protection, but settlements remain trivial and enforcement patchy. Most Chinese patents granted to domestic applicants are still of a type known as "utility model" patents, mainly awarded for incremental improvements, rather than for innovation or new designs (see chart 3).

The weakness of intellectual-property rights can be seen as part of a deeper problem: the weakness of private property rights in general. Before China's reopening in the late 1970s, says a recent study on Chinese innovation by the OECD, this issue did not arise: innovation and technological development were assigned to government institutes; factories received work orders. Even today only the rarest company can claim unfettered independence. According to Yasheng Huang, an economist at the Massachusetts Institute of Technology, explicitly state-controlled firms make up half the economy. That probably understates the true effect, because even private firms understand that their existence depends on their relations with the state.



In state-controlled companies, senior managers are rotated at the behest of government. China Mobile is said to have 100,000 suppliers. One reason is that with its management and operating franchise subject to frequent government intervention (it was reorganised last summer), technological innovation must be done outside. Leading managers have low salaries and often let stock options expire even when they are in the money, which suggests that rewards are not closely tied to creating value for shareholders.

Medium-sized companies have their own conflicts. Factories inevitably occupy land that was once state-held. As a consequence, their shareholders often include local government. Officials have little interest in industrial efficiency: mergers, for instance, are unattractive if they mean losses of local jobs. Invariably, if there is a photograph on a wall at a corporate headquarters, it features a visit by a senior government official—showing who matters.

Blurred ownership distorts finance, management structure and long-term planning. To insulate themselves

from the vicissitudes of China’s state control, companies go through all manner of legal contortions when they list shares. Haier, for example, is incorporated in Bermuda. Securities offerings must be approved by the government and the bulk of legal financing comes from state-controlled banks. With all these political ties, lack of innovation is hardly a surprise.

Theoretically, the smaller, private firms are more flexible. But raising money is hard: loans to such firms account for only a small part of the total lending by those state-controlled banks (see chart 4). The source of small firms’ money is one of China’s great mysteries, but there are hints. China is filled with grey-market financiers, including pawn shops, “credit-guarantee” firms, and small industrial companies that lend to other small industrial companies. Because finance from such sources is informal, however, it is short-term, changing the nature of investment. It often depends on the personal relationships of the firm’s owner; that too can distort managerial decision-making.

None of these impediments has prevented China from growing. Indeed, the extraordinary way in which money, people and companies seem to come and go illustrates the country’s adaptability. But they are impediments all the same.

Two years ago, on one of his frequent trips to China, Bill Gates said he was often asked where the next Bill Gates and the next Microsoft might emerge. To the delight of his government hosts, he predicted Asia, because of the changes he had witnessed, the level of education and the impact of technology. It is easy to imagine that someone from China might follow in Mr Gates’s footsteps. In today’s conditions it is, alas, hard to imagine that someone from a Chinese company might do so.

Financial fraud

Howzat!

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From The Economist print edition

Shocking allegations against Stanford Group, so soon after the arrest of Bernard Madoff, suggest this will be a fraud-infested downturn

AFP

HOUSTON has not seen anything like it since the collapse of Enron. On February 17th federal agents swooped on Sir Allen Stanford's financial group, seizing mountains of documents, and a judge placed it in the hands of a receiver. The obvious parallel, however, was not the defunct energy firm but Bernard Madoff. Charges filed by the Securities and Exchange Commission (SEC) portray the flamboyant Sir Allen (pictured on the right above) as the Ponzi-master's offshore equivalent, perpetrating a fraud of "shocking magnitude" based on "false promises" and fabricated performance data, primarily through his Antigua-based bank.

The central allegation is that Stanford International Bank hoodwinked investors over the safety and liquidity of uninsured certificates of deposit (CDs). It took in some $8 billion, consistently offering rates well above those of big banks—sometimes more than twice as high. Despite assurances that the money was going into liquid securities, much of it was apparently ploughed into sticky assets such as property and private equity.

How well these performed is unclear, but the stated returns were suspiciously smooth and impressive: consistently in the low double digits for over a decade, with a loss of just 1.3% last year, when stockmarkets around the world crashed.

Unlike Mr Madoff, Sir Allen has not been accused of running a Ponzi scheme, though it is possible that large sums have been lost in unwise bets. Many of the bank's 30,000 clients tried—unsuccessfully—to withdraw their money this week, some even descending on its neo-Georgian headquarters near the airport of St John's, the Antiguan capital. Depositors also besieged Stanford's smaller, onshore Bank of Antigua, as well as operations in Venezuela and Panama. A big chunk of the client base is Latin American—reportedly, America's Federal Bureau of Investigation is investigating whether he had money-laundering links to a Mexican drugs cartel. Americans are said to have ploughed in as much as $1.5 billion. In total, the group claims to have more than $50 billion "under advisement".

The hoodwinking ran deep, according to the SEC's complaint. The portfolio was not, as claimed, monitored by a team of more than 20 analysts, but by the sole shareholder himself and his chief financial officer, an old college classmate. Among those on the cosy investment committee were Sir Allen's father and a neighbour with cattle-ranching experience.

Investors can perhaps be forgiven for failing to spot this inbred governance structure. Other warning signs were more obvious: the implausibly small auditing firm that Stanford used—like Mr Madoff; and a stunning lack of transparency. The chief investment officer told staff not to reveal too much about the oversight of investments because it "wouldn't leave an investor with a lot of confidence".

Once again, regulators are shuffling uncomfortably in the spotlight. Antigua's financial regulator has lived down to its reputation for being supine even by Caribbean standards. It gave Stanford a clean bill of health a few months ago. Sir Allen's local clout and political connections may have helped here. His knighthood came from a grateful Antiguan government, not Queen Elizabeth.

American regulators have been more assiduous, though are still open to charges of foot-dragging. FINRA, which oversees brokers, has fined Stanford several times in recent years, including a $10,000 penalty for misrepresenting the "risks and potential benefits" of its CDs. Such a small fine will fuel suspicion that the self-regulatory body is too close to the industry. The SEC, still smarting from its failure to unearth Mr Madoff's alleged tricks, began probing Stanford as far back as 2006.

Even then, it was arguably late. Law enforcers had been sniffing around Sir Allen since the late 1990s, after he lost his banking licence in Montserrat, another Caribbean island. His group's murkiness has long alarmed those who looked closely. "There was no excuse for anyone with an ounce of sophistication to invest," says David Marchant of *Offshore Alert*, a newsletter. The SEC stepped up its probe after the Madoff revelations. But a bigger impetus may have been a deeply sceptical report in January by Alex Dalmady, an independent analyst. The blogosphere picked this up, and within days it was making headlines worldwide. This offers hope for those who despair of the SEC's bungling, suggesting that in the internet age forensic vigilantes and bloggers may fill the gap.

Book-cookers have long been drawn to offshore finance. The difference this time is the profile of the alleged perpetrator. Sir Allen strenuously cultivated an image of respectability as an entrepreneur, philanthropist and sports impresario. He sponsored golf and tennis tournaments. But his main devotion was to cricket (and, as witnesses to his flirting can attest, its players' wives). His grand project was a $20m-per-game competition featuring a West Indian team, the "Stanford Superstars".

This second allegation of massive fraud in as many months is unlikely to be the last. Downturns expose old shenanigans and encourage new ones, as executives gamble for salvation. This may be particularly true for money managers, hit by rising redemption requests and falling returns and inflows: Stanford's fate was probably sealed when it started to block redemptions, after clients asked for $1.3 billion back in the last quarter of 2008.

If this is the beginning of an ugly trend, all but the strongest money managers have reason to fret. JPMorgan Chase's private bank saw a record $80 billion of net inflows last year as investors fled less pukka firms. But those investors should ask questions of themselves, too. How did Stanford attract so many despite being a complex, opaque operation in a lightly regulated jurisdiction, offering oddly stable returns?

They may yet get much of their money back, but the amount left in the pot is anyone's guess. Sir Allen has vowed to clear his name, but refusing to co-operate was perhaps not the best start. As *The Economist* went to press his whereabouts were unknown. According to reports—which may well be apocryphal—Sir Allen had tried to charter a corporate jet near Houston, but was turned away because the operator would not take his credit card.

Economist.com FINANCE & ECONOMICS

Buttonwood

Debtors' prison

Feb 19th 2009
From The Economist print edition

Companies made a fashionable mistake

Illustration by S. Kambayashi

CHIEF executives get no credit in good times if their companies have good credit. Back in 1980 more than 60 American non-financial companies qualified for the ultra-chic AAA rating from Standard & Poor's (S&P). Now there are just six.

That change is not just a reflection of the financial crisis or the recession. The decline in credit ratings has been remorseless over the past couple of decades. In 1987 just 38.1% of issuers in the American bond market were rated as speculative, or "junk". In 2007 junk-bond issuers made up most of the market for the first time. The number of lowly-rated CCC issuers has almost tripled over the past 21 years.

The intellectual fashion has been for companies to have "efficient" balance-sheets. If cash is not immediately needed to reinvest in the business, it should be handed back to shareholders, who can use it more profitably elsewhere. Hoarding cash for a rainy day was seen as a failure of executive imagination.

Corporate-finance theory may state that the value of a company should not be affected by its decision to finance itself with equity or debt. But, in practice, interest payments are generally tax-deductible; dividends are not. That gives companies a big push in the direction of debt.

So has the state of the financial markets in recent years. Measures of stockmarket valuation, such as price-earnings ratios, never recovered to the peak levels of 2000, even when share prices were rising during 2003-07. In contrast, corporate-bond investors quickly forgave issuers for the failures of Enron and WorldCom in 2002; spreads fell to historic lows. It was easier to issue debt than equity.

In addition, debt was credited with operational benefits. The need to meet regular payments imposes a discipline on corporate executives, ensuring they keep a lid on costs. This is one of the arguments used to extol the merits of private equity, which relies heavily on debt finance.

But these strategic reasons for taking on debt may have played second fiddle to a more basic motive: managers' self-interest. Using cash to buy back equity boosted earnings per share, making it easier for companies to meet quarterly profits targets. Meanwhile, executives are motivated by share options. Favouring debt over equity made the share price more volatile, and the more volatile the shares, the more valuable an option becomes.

Debt was also often used to finance acquisitions. Again, deals may be in the executive's self-interest; bigger companies mean bigger salaries and it is much better for the executive if his company is perceived to be predator, not prey. Moreover, outside advisers, such as investment banks, have an incentive to recommend debt issuance and acquisitions, both of which generate fees. Activist shareholders such as hedge funds pushed companies to pay out surplus cash.

It is only in recessions that this enthusiasm for debt reveals its dangers. The default rate is now rising rapidly and S&P is forecasting that nearly 14% of bond issuers will fail to meet their obligations this year. It is difficult to roll over new debt, given the credit crunch. Meanwhile, suppliers demand instant payment from companies with weak balance-sheets and equity investors downgrade the shares.

Were there no voices for caution? To be fair, it was households rather than business that piled up the bulk of the debt in recent years. Strong profits allowed many companies to rely on internal funds for their investment needs. However, in a few industries, carmaking, for example, debt has been pushed very high.

And many public companies that were taken private in recent years are now struggling to cope with their debts.

Companies will naturally now seek to issue shares to repair their balance-sheets. Sometimes this will mean selling equity, a galling experience for those who spent a fortune on share buy-back programmes just a year or two ago. That ought to cast doubt on the financial acumen of the executives concerned.

A bigger problem is that the best time to issue shares is when stockmarkets are soaring, not languishing. Figures from Absolute Strategy Research, a consultancy, show that the peak period for European issuance was in 1998-2000, in monetary terms, or in 1986-88, as a proportion of market value.

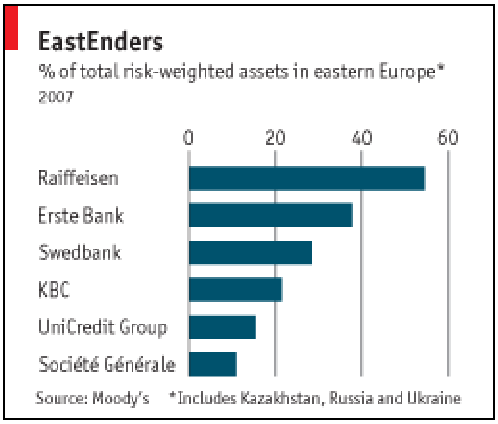
In recessions, rights issues can seem like chucking good money after bad. And as the banks have already discovered, the more a rights issue appears to be imminent, the bigger the fall in the share price and the harder it is to get the issue away. The “efficient” balance-sheet can be a disorderly death sentence.

Eastern European banks

The ties that bind

Feb 19th 2009
From The Economist print edition

Will west European banks abandon their eastern subsidiaries?



When companies brandish maps of their conquests, trouble usually follows. For some west European banks in recent years, the cartography in question tracked their efforts to hoover up lenders in central and eastern Europe (CEE). Depending on how this area is defined—some stretch it as far as Kazakhstan—up to four-fifths of bank assets are foreign-owned.

The global crisis has abruptly ended eastern Europe's credit-fuelled boom. Estimates of output have slumped and currencies have dropped as capital inflows have dried up. Credit-default swaps on sovereign debt, which measure the risk of default, have risen, generally to more alarming levels the further east you go. When governments are at risk of default, banking systems typically get into deep trouble. The contagion has thus hit western banks with high exposure to CEE (see chart), and the countries where they are headquartered. Austria, which hosts Raiffeisen and Erste Bank, has loans to the wider region of €230 billion ($293.5 billion), equivalent to about 80% of Austrian GDP. Austria's government-bond yields have risen close to the levels of Italy, the euro zone's habitual miscreant. Worries that the euro zone will have to bail out its eastern cousins have hit the single currency.

For western banks involved in eastern Europe there are three main risks. First that bad debts rise as local customers default, particularly those that have borrowed in foreign currencies that have since risen relative to their own. Second that foreign-exchange mismatches mean the assets of local banking subsidiaries shrink relative to liabilities, eating up capital. And finally that subsidiaries face deposit runs or are unable to borrow. In any of these situations, the western parent would have to step in with precious capital and liquidity.

Or would it? Moody's, a credit-rating agency, says it has "concerns" about the "supportiveness" of western parent banks to their local subsidiaries, the liabilities of which they do not typically guarantee. In a simplified scenario, a western bank facing life-threatening losses could just walk away, limiting the hit to a write-off of the equity it had invested in the subsidiary.

Just how feasible that is can be debated. One of the dirty habits from the boom is that as local loan growth outpaced deposit growth, western parents funded the gap by lending to their local subsidiaries. This is far from being a universal habit—Erste and Belgium's KBC say they have little such exposure and some of Unicredit's local units fully fund themselves. But some parents have more to lose than just their equity investment.

Then there is reputational risk, which for banks, dependent on confidence from depositors and sophisticated wholesale lenders, is hard to overestimate. When Argentina's government defaulted in 2001, some blue-chip companies allowed their local subsidiaries to fail—France Telecom and Telecom Italia let Telecom Argentina default. But big western banks, like Santander, held firm. All of which suggests that banks will do their utmost to back their subsidiaries. A few may find they have the will but lack the means, and may be headquartered in countries that eventually refuse to backstop their empires. For these lenders break-up beckons, with national governments taking on their respective bits. Eastern Europeans keen to learn how to bail out a cross-border bank need only look west to Benelux and the dismemberment of Fortis.

China's economy

Perhaps a reason to be cheerful?

Feb 19th 2009 | SHANGHAI
From The Economist print edition

For those looking gamely for bright spots, China flickers

CHINA is in the grip of a severe drought. In contrast, its banking system is awash with liquidity. Whereas most economies are being squeezed by a credit crunch, Chinese bank lending surged by 21% in the year to January. There are a few other hopeful signs. Are these the first green shoots of spring?

Not necessarily. There are reasons to remain worried about China's immediate prospects. Unfortunately, official statistics are of no help in tracking the path of China's output and demand: the National Bureau of Statistics has decided not to release January figures for industrial production, investment or retail sales because they are distorted by the Chinese new year holiday. In 2008 it fell in February, this year in January, which means that last month had only 17 working days compared with 22 last year. To avoid the statistical noise, January figures for economic activity will be released at the same time as the February ones. Meanwhile, China watchers are having to look elsewhere.

One cheery sign is share prices, which have jumped by 30% since November—although they fell sharply this week. Some optimists have also pounced on the purchasing managers' index, a gauge of manufacturing activity, which increased in January for the second month running.

But the most hopeful sign is the surge in bank lending. Credit controls were lifted in October and banks have been quick to turn on the tap. New loans in January were twice as big as a year earlier—even though the banks were closed during the holiday.

Sceptics note that a large chunk of the increase is accounted for by short-term bills rather than new lending to finance spending. Some "new" loans also represent a shift to the formal banking sector from off-balance sheet vehicles and from the informal loan market which flourished when credit quotas were in place.

But medium- and long-term lending has also increased strongly, suggesting that the government's stimulus package has started to kick in. The central government plans to finance only 30% of the 4 trillion yuan ($585 billion) infrastructure package; banks are expected to provide much of the rest. Some shovel-ready projects are already under way. According to Tim Condon, at ING, transport infrastructure spending in December was already 61% higher than a year earlier.

China can quickly mobilise lending for two reasons. First, the big banks are state-owned and their chairmen appointed by the government, so they tend to follow Beijing's orders. Second, as Tao Wang of UBS argues, domestic debt has fallen relative to GDP in recent years; banks' loan-to-deposit ratio of 65% is low by global standards; and firms, banks and households have relatively clean balance-sheets.

The expectation of increased spending on roads and railways has helped to lift raw-material prices. Chinese prices of steel have risen by 20% since November, and the Baltic Dry Index, a measure of shipping rates and hence the demand for commodities, has more than doubled, although it is still 84% below its 2008 peak. This suggests that firms are rebuilding stocks of raw materials. However, according to Stephen Green, at Standard Chartered, stocks of finished goods are still rising, which will curb production over the next few months. Because of this, the economic numbers are likely to get worse before they get better. The first shoots of spring are often vulnerable to a frost.

China's economy

Perhaps a reason to be cheerful?

Feb 19th 2009 | SHANGHAI
From The Economist print edition

For those looking gamely for bright spots, China flickers

CHINA is in the grip of a severe drought. In contrast, its banking system is awash with liquidity. Whereas most economies are being squeezed by a credit crunch, Chinese bank lending surged by 21% in the year to January. There are a few other hopeful signs. Are these the first green shoots of spring?

Not necessarily. There are reasons to remain worried about China's immediate prospects. Unfortunately, official statistics are of no help in tracking the path of China's output and demand: the National Bureau of Statistics has decided not to release January figures for industrial production, investment or retail sales because they are distorted by the Chinese new year holiday. In 2008 it fell in February, this year in January, which means that last month had only 17 working days compared with 22 last year. To avoid the statistical noise, January figures for economic activity will be released at the same time as the February ones. Meanwhile, China watchers are having to look elsewhere.

One cheery sign is share prices, which have jumped by 30% since November—although they fell sharply this week. Some optimists have also pounced on the purchasing managers' index, a gauge of manufacturing activity, which increased in January for the second month running.

But the most hopeful sign is the surge in bank lending. Credit controls were lifted in October and banks have been quick to turn on the tap. New loans in January were twice as big as a year earlier—even though the banks were closed during the holiday.

Sceptics note that a large chunk of the increase is accounted for by short-term bills rather than new lending to finance spending. Some "new" loans also represent a shift to the formal banking sector from off-balance sheet vehicles and from the informal loan market which flourished when credit quotas were in place.

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Remittances

Trickle-down economics

Feb 19th 2009
From The Economist print edition

Migrants are less fickle sources of cash than foreign creditors

AP

The last redoubt of cross-border finance

QUEUES of migrant workers waiting to send money to their families hardly present globalisation at its most glamorous. But such remittances made up more than a fifth of the GDP of some countries such as Jamaica, Jordan, Lebanon, Moldova and Tajikistan in 2007.

Data compiled by researchers at the World Bank suggest that remittances may have another virtue that is less widely appreciated. Although they are likely to fall as a result of the slumping world economy, they may be less fickle than more publicised private-capital flows, such as equity and lending by foreign banks.

Private-capital flows have plunged in the past year, and are continuing to fall. The Institute of International Finance (IIF), a global banking body, reckons that net private-capital inflows into emerging economies fell from $929 billion in 2007 to $466 billion in 2008, a drop of nearly 50%. And 2009 will see only $165 billion flow to emerging economies, according to the IIF.

All of which makes remittances to developing countries more precious, and questions about their resilience more pressing. New estimates from the World Bank put the flows as high as $305 billion in 2008, up from $281 billion in 2007. And although all regions except South Asia saw a slowdown in the rate of growth in 2008 (and data for Mexico show an outright decline of 3.6%), the very fact that they still rose in most places is good news, given the collapse in other private financial flows to the developing world.

But not necessarily surprising, according to Dilip Ratha, the bank’s main expert on the subject. Remittances, he argues, are less dependent on the growth prospects of receiving countries than other kinds of flows, which seek profitable investment opportunities. Sending money home is often a motive for emigrating, so that migrants remit money even in lean times. And because the sums sent home tend to be small—typically around 5% of a migrant’s income—people can keep the cross-border payments going even when their incomes fall.

Migration from poor countries to rich ones is bound to decline, as the recession means fewer jobs for migrants and, in some countries, as immigration rules and border controls are tightened. However, the impact of this on remittances may be softened by the fact that most of the money comes from long-standing migrants, whose contributions dwarf any flows from new arrivals, who are only 2-4% of the total migrants in a typical year.

None of this means that remittances will continue to grow. According to the Pew Hispanic Centre, a research body, among Hispanic migrants who remitted money in the past two years, 71% said they sent less in 2008 than the year before. Regular remittances may shrink if people, having lost their jobs, return

home in large numbers. Remittances may rise in the short term, though, as returning migrants repatriate their savings. Then the flows will drop off precipitously. If that is already happening, the figures for 2008 could understate the impact of the crisis.

The bank thinks the most likely outcome for 2009 will be a decline in remittances of just under 6%, though not enough is known about the impact of severe recessions to be sure of such predictions. The bank expects remittances to recover in 2010—but that, too, is based on hope as much as experience.

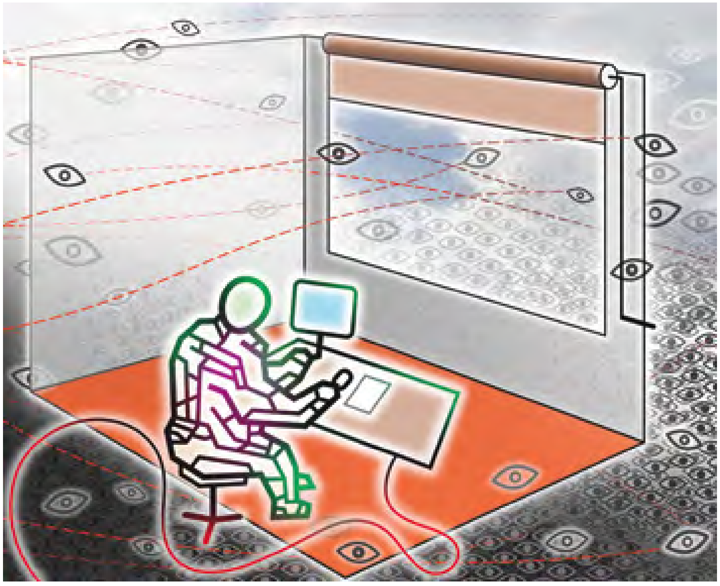
Economics focus

Full disclosure

Feb 19th 2009
From The Economist print edition

The case for transparency in financial markets is not clear-cut

Illustration by Jac Depczyk



ITS promises are alluring, yet elusive; everyone, from politician to pundit, calls for more. In its recent report on financial reform, the Group of Thirty, a body of financial experts, mentioned it more than 30 times. Transparency is in vogue. Yet few ask whether it actually works.

Not long ago the cheerleaders of opacity were the loudest. Without privacy, they argued, financial entrepreneurs would be unable to capture the full value of their trading strategies and other ingenious intellectual property. Forcing them to disclose information would impair their incentive to uncover and correct market inefficiencies, to the detriment of all. And for years the so-called shadow banking system thrived, away from prying eyes. Then crisis hit, lending weight to the quip "What you see is what you get; what you don't see gets you." Few saw it coming, but if a lack of transparency was pervasive, how could they have?

As clear as mortgage-backed securities

"Sunlight is said to be the best of disinfectants," wrote Louis Brandeis, later a Supreme Court justice, in 1913, and almost a century later his words have become a maxim. Yet transparency is amorphous; it can, frustratingly, be anything but transparent and, implemented wrongly, may harm the very interests it is supposed to serve. In financial markets, the word is nearly always equated with information disclosure. The trouble is that the information is often incomplete, irrelevant or outright incomprehensible. Subprime-mortgage-backed securities are a case in point. These instruments—whose value remains shrouded in mystery—can have prospectuses of about 500-600 pages, most of which are devoted to intricate legalese. Yet, inexplicably, they do not contain the information about individual loans that is needed to detect default risk.

Nor is transparency free. The Sarbanes-Oxley act, which partly restored confidence after the scandals of Enron, WorldCom and others, came at a cost—not only in terms of the burden of compliance it imposed on companies. In order to shield small firms, those with a stockmarket value of less than $75m were initially exempted. This created a peculiar incentive: at least one study suggests that firms just below the threshold began disbursing unusual amounts of cash to shareholders and making fewer investments. The act has also been accused of stifling risk-taking and increasing directors' pay.

At its onset, the turmoil in financial markets was described as a liquidity crisis. And transparency and liquidity are close relatives. One enemy of liquidity is "asymmetric information". To illustrate this, look at a variation of the "Market for Lemons" identified by George Akerlof, a Nobel-prize-winning economist, in 1970. Suppose that a wine connoisseur and Joe Sixpack are haggling over the price of the 1998 Château Pétrus, which Joe recently inherited from his rich uncle. If Joe and the connoisseur only know that it is a red wine, they may strike a deal. They are equally uninformed. If vintage, region and grape are disclosed, Joe, fearing he will be taken for a ride, may refuse to sell. In financial markets, similarly, there are sophisticated and unsophisticated investors, and unless they have symmetrical information, liquidity can dry up. Unfortunately transparency may reduce liquidity. Symmetry, not the amount of information, matters.

The good news is that transparency can work. When information is relevant, standardised and public, it fosters intelligent decision-making. Lenders, for instance, are required to quote interest rates as annual percentage rates, making loans easy to compare. Some behavioural economists call this "simplified transparency", and think similar requirements should be imposed on complex financial products. Information must also be accurate as the credit-rating debacle shows: an AAA rating is harmful rather than helpful if it describes a CCC asset.

But politics impedes the ideal of transparency for at least two reasons. First, the benefits of transparency are widely dispersed among information users, whereas the costs are borne by few information disclosers; the disclosers therefore dominate the political process. Second, disclosure requirements are often drawn up after crises. They therefore tend to be hurried and haphazard, and support for them fades with memory of the hard times.

And even well-designed disclosure requirements may not suffice. People may make ill-informed choices, simplified transparency or not. In a recent study, two groups (made up of Harvard University staff) were asked to pick mutual funds. One group was given prospectuses which neatly summarised the funds' objectives, risk profiles, costs and past performance in a few pages. The other group received the standard long-winded and hard-to-understand prospectuses. They nonetheless made nearly identical choices, opting for funds with good past performance and largely neglecting fees. Academic research suggests that people should do precisely the opposite.

Still, for all its difficulties, transparency is usually better than the alternative. The opaque innovations of the recent past, rather than eliminating market inefficiencies, unintentionally created systemic risks. The important point is that financial markets are not created equal: they may require different levels of disclosure. Liquidity in the stockmarket, for example, thrives on differences of opinion about the value of a firm; information fuels the debate. The money markets rely more on trust than transparency because transactions are so quick that there is little time to assess information. The problem with hedge funds is that a lack of information hinders outsiders' ability to measure their contribution to systemic risk. A possible solution would be to impose delayed disclosure, which would allow the funds to profit from their strategies, provide data for experts to sift through, and allay fears about the legality of their activities. Transparency, like sunlight, needs to be looked at carefully.

The American Association for the Advancement of Science

What's cooking?

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From The Economist print edition

Mary Evans

The evolutionary role of cookery

YOU are what you eat, or so the saying goes. But Richard Wrangham, of Harvard University, believes that this is true in a more profound sense than the one implied by the old proverb. It is not just you who are what you eat, but the entire human species. And with *Homo sapiens*, what makes the species unique in Dr Wrangham's opinion is that its food is so often cooked.

Cooking is a human universal. No society is without it. No one other than a few faddists tries to survive on raw food alone. And the consumption of a cooked meal in the evening, usually in the company of family and friends, is normal in every known society. Moreover, without cooking, the human brain (which consumes 20-25% of the body's energy) could not keep running. Dr Wrangham thus believes that cooking and humanity are coeval.

In fact, as he outlined to the American Association for the Advancement of Science (AAAS), in Chicago, he thinks that cooking and other forms of preparing food are humanity's "killer app": the evolutionary change that underpins all of the other—and subsequent—changes that have made people such unusual animals.

Humans became human, as it were, with the emergence 1.8m years ago of a species called *Homo erectus*. This had a skeleton much like modern man's—a big, brain-filled skull and a narrow pelvis and rib cage, which imply a small abdomen and thus a small gut. Hitherto, the explanation for this shift from the smaller skulls and wider pelvises of man's apelike ancestors has been a shift from a vegetable-based diet to a meat-based one. Meat has more calories than plant matter, the theory went. A smaller gut could therefore support a larger brain.

Dr Wrangham disagrees. When you do the sums, he argues, raw meat is still insufficient to bridge the gap. He points out that even modern "raw foodists", members of a town-dwelling, back-to-nature social movement, struggle to maintain their weight—and they have access to animals and plants that have been bred for the table. Pre-agricultural man confined to raw food would have starved.

Firelight

Start cooking, however, and things change radically. Cooking alters food in three important ways. It

breaks starch molecules into more digestible fragments. It “denatures” protein molecules, so that their amino-acid chains unfold and digestive enzymes can attack them more easily. And heat physically softens food. That makes it easier to digest, so even though the stuff is no more calorific, the body uses fewer calories dealing with it.

In support of his thesis, Dr Wrangham, who is an anthropologist, has ransacked other fields and come up with an impressive array of material. Cooking increases the share of food digested in the stomach and small intestine, where it can be absorbed, from 50% to 95% according to work done on people fitted for medical reasons with collection bags at the ends of their small intestines. Previous studies had suggested raw food was digested equally well as cooked food because they looked at faeces as being the end product. These, however, have been exposed to the digestive mercies of bacteria in the large intestine, and any residual goodies have been removed from them that way.

Another telling experiment, conducted on rats, did not rely on cooking. Rather the experimenters ground up food pellets and then recompacted them to make them softer. Rats fed on the softer pellets weighed 30% more after 26 weeks than those fed the same weight of standard pellets. The difference was because of the lower cost of digestion. Indeed, Dr Wrangham suspects the main cause of the modern epidemic of obesity is not overeating (which the evidence suggests—in America, at least—is a myth) but the rise of processed foods. These are softer, because that is what people prefer. Indeed, the nerves from the taste buds meet in a part of the brain called the amygdala with nerves that convey information on the softness of food. It is only after these two qualities have been compared that the brain assesses how pleasant a mouthful actually is.

The archaeological evidence for ancient cookery is equivocal. Digs show that both modern humans and Neanderthals controlled fire in a way that almost certainly means they could cook, and did so at least 200,000 years ago. Since the last common ancestor of the two species lived more than 400,000 years ago (see following story) fire-control is probably at least as old as that, for they lived in different parts of the world, and so could not have copied each other.

Older alleged sites of human fires are more susceptible to other interpretations, but they do exist, including ones that go back to the beginning of *Homo erectus*. And traces of fire are easily wiped out, so the lack of direct evidence for them is no surprise. Instead, Dr Wrangham is relying on a compelling chain of logic. And in doing so he may have cast light not only on what made humanity, but on one of the threats it faces today.

Neanderthal genetics

Basic information

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From The Economist print edition

The first draft of the genome of humanity's closest relative

CHARLES DARWIN was born on February 12th 1809. So it was appropriate that Svante Paabo of the Max Planck Institute for Evolutionary Anthropology, in Leipzig, chose Darwin's 200th anniversary to announce what would, until recently, have been thought an impossible discovery in evolutionary biology—a draft of the genome of Neanderthal man.

Dr Paabo made his announcement to the AAAS meeting via a video link from Germany, and followed it up by a lecture in person on the 15th. The Neanderthal Genome Project, as it is known, is the culmination of a career devoted to the examination of ancient DNA by a man whose work provided inspiration for Michael Crichton's novel and film "Jurassic Park".

Neanderthals lived in Europe and western Asia from 400,000 to some 30,000 years ago. They were thus contemporary with modern *Homo sapiens*, who originated in Africa about 200,000 years ago. The disappearance of Neanderthals coincided with the arrival of *Homo sapiens* in their range, and there has been much speculation about whether the interlopers were to blame, if there was interbreeding, and which features of modern humanity, such as language, Neanderthals also possessed.

In an attempt to answer some of these questions, Dr Paabo and his team extracted DNA from Neanderthal fossils excavated at four sites, including the original specimen discovered in the Neander valley in Germany in 1856. Unlike the DNA in the Human Genome Project, this fossil DNA was in tiny pieces and heavily contaminated with DNA from bacteria and fungi. Purifying it involved a clever trick using enzymes that can identify and destroy the genetic material of micro-organisms without also destroying too much of the DNA of interest. Once purified, the Neanderthal fragments were fed into DNA-sequencing machines many times more powerful than those used to work out the human sequence, so that the whole project took only about two and a half years, instead of being a multinational effort lasting a decade.

The Neanderthal genome, at just over 3 billion pairs of chemical bases (the genetic "letters"), is about the same size as a modern human one, and Dr Paabo's team were indeed able to extract and feed 3.7 billion base-pairs-worth of DNA into their machines. Such so-called one-fold coverage does not, however, provide a full sequence since many parts of the genome are represented more than once, whereas others are missing completely. Statistically, one-fold coverage gives you about 60% of the genome, and that is what Dr Paabo's first draft has achieved.

This is, nevertheless, enough to start answering questions. So far, Dr Paabo has been able to show, from the overall amount of difference between the DNA of the two species, that the Neanderthal line and that of modern humanity parted company only shortly before the oldest known Neanderthal fossils were alive. Both species descend from a third, called *Homo erectus*, that lived in both Africa and Asia, but the fossil record of *Homo erectus* and its immediate successors is fragmentary and confusing. This work should thus provide important extra evidence about the details of what happened. It suggests, too, that if there was any interbreeding between Neanderthals and modern humans, this was trivial and is not represented in the modern human population.

The team has also looked at a few genes of particular interest. The most famous of these is FOXP2, damage to which prevents speech in modern humans. Neanderthals turn out to have the same version of FOXP2 as *Homo sapiens* (and thus a different one from chimpanzees). Researchers are divided about how significant FOXP2 really is, because it is involved in the mechanics of speech production, not the mental abilities that lie at the root of language. But some regard this discovery as evidence that Neanderthals could speak.

Much more information should emerge as Dr Paabo increases his one-fold coverage to 20-fold, the point at which almost every base pair is represented. At that moment, science will have in its grasp the genetic details of what is probably modern humanity's closest relative—an extraordinary achievement which

should help in the struggle to unravel what makes modern humans such extraordinary animals. A suitable, if belated, birthday present, then, for biology’s presiding genius.

Education

A handwaving approach to arithmetic

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Gesticulating helps children to learn

HUMAN language is the subject of endless scientific investigation, but the gestures that accompany speech are a surprisingly neglected area. It is sometimes jokingly said that the way to render an Italian speechless is to tie his wrists together, but almost everyone moves their hands in meaningful ways when they talk. Susan Goldin-Meadow of the University of Chicago, however, studies gestures carefully—and not out of idle curiosity. Introspection suggests that gesturing not only helps people communicate but also helps them to think. She set out to test this, and specifically to find out whether gestures might be used as an aid to children's learning. It turns out, as she told the AAAS, that they can.

The experiment she conducted involved balancing equations. Presented with an equation of the form 2 + 3 + 4 = x + 4, written on a blackboard, a child is asked to calculate the value of x. In the equations Dr Goldin-Meadow always made the last number on the left the same as the last on the right; so x was the sum of the first two numbers. Commonly, however, children who are learning arithmetic will add all three of the numbers on the left to arrive at the value of x.

In her previous work Dr Goldin-Meadow had noted that children often use spontaneous gestures when explaining how they solve mathematical puzzles so, to see if these hand-movements actually help a child to think, or are merely descriptive, she divided a group of children into two and asked them to balance equations. One group was asked to gesture while doing so. A second was asked not to. Both groups were then given a lesson in how to solve problems of this sort.

As Dr Goldin-Meadow suspected, the first group learnt more from the lesson than the second. By observing their gestures she refined the experiment. Often, a child would touch or point to the first two numbers on the left with the first two fingers of one hand. Dr Goldin-Meadow therefore taught this gesture explicitly to another group of children. Or, rather, she taught a third of them, taught another third to point to the second and third numbers this way, and told the remainder to use no gestures. When all were given the same lesson it was found those gesturing "correctly" learnt the most. But those gesturing "incorrectly" still outperformed the non-gesturers.

Gesturing, therefore, clearly does help thought. Indeed, it is so thought-provoking that even the wrong gestures have some value. Perhaps this helps to explain why the arithmetic-intensive profession of banking was invented in Italy.

Exobiology

The lonely planet guide

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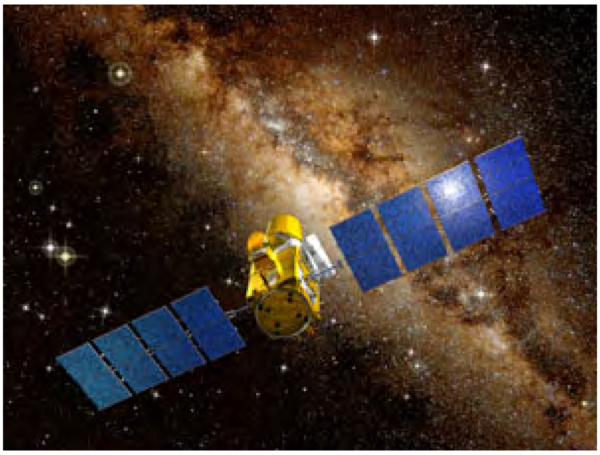
From The Economist print edition

Attempts to find alien life on Earth and elsewhere

IN A book called "Life, the Universe and Everything", Douglas Adams imagined a planet called Krikkit that was enrobed in a dust cloud so thick that its inhabitants could not see the universe beyond. They lived in happy isolation under an ink-black sky until, one day, an alien space ship crashed into their world and they discovered they were not alone. This, they decided, was unacceptable, so they set out to destroy the rest of lifekind.

Humanity's problem is the opposite of the Krikkiters'. Earthlings know that the universe is vast but, paradoxically, they do not know whether they are alone in it. It is not merely the lack of abandoned flying saucers. There is no unequivocal sign of even the most humble bacterial life on any astronomical body within the range of human telescopes. That bothers a lot of people. At the AAAS meeting in Chicago, astronomers therefore discussed how planets form and the chances of finding alien life thereon.

European Space Agency



Anyone out there?

Some 340 planets have now been found orbiting stars other than the sun and, earlier this month, a French spacecraft called *COROT* (illustrated) discovered the smallest yet. Most such exoplanets are gaseous giants bigger than Jupiter. These are incapable of supporting life-as-we-know-it. However COROT-Exo-7b, as the newly located orb is known, is only slightly larger than Earth and is thought to have a rocky surface.

Sadly for those people seeking extraterrestrial life, COROT-Exo-7b lies so close to its parent star that it is far too hot for organisms of the terrestrial sort to survive. Yet astronomers are confident they will soon detect many more rocky exoplanets by using *COROT* and later an American craft called *Kepler*, that is due to be launched on March 5th. Some of these exoplanets will surely orbit their stars at a distance that allows their water to be liquid.

Moonshine

An exoplanet that had a large moon would be of particular interest. The moon's presence creates tides on Earth and many exobiologists, as those hopeful scientists who aspire to study organisms on other planets are known, think these may be important for the origin and maintenance of life. Tides churn the oceans. That is reckoned to be good for life as it mixes up chemicals and organisms, encouraging small ones to grow, which provides food for large ones.

If a tide-causing moon does enhance the chance of life flourishing on a planet, then aliens may be abundant. That is because such moons should be quite common around Earth-like planets, according to Robin Canup of the Southwest Research Institute in Boulder, Colorado. Dr Canup has deduced this by using a computer to simulate the process by which the Earth acquired its moon.

The favoured story to explain where the moon came from is of an iron-rich object the size of Mars hitting the Earth while it was forming. Much of the iron in the smaller planet ended up as the Earth's core, whereas the cloud of dust that was ejected by the impact consolidated into the body now known as the moon.

The impact may even have triggered plate-tectonic activity, which causes the continents to move around. Many biologists think this, too, is good for life, because it mixes up the crustal rocks rather as the tides mix the oceans, albeit far more slowly. Dr Canup's models of developing solar systems suggest that in any system there is about a 15% chance of the type of collision which created the Earth and moon.

It is one thing, though, to have the right conditions for life. It is another for life to form. At the moment, no one has any idea how easy it is for living organisms to come into existence, and no one has got close to replicating the process in a laboratory. Steven Benner of the Foundation for Applied Molecular Evolution, a private educational organisation based in Gainesville, Florida, may, however, have taken the first step. He announced to the meeting that he had made a biochemical "soup" capable of Darwinian evolution.

He did it by adding two synthetic nucleotides to the four natural ones that act as the letters of the genetic code in DNA. The result is a substance that is no longer DNA, but which behaves somewhat like it. Using a commonplace technique called the polymerase chain reaction, Dr Benner was able to persuade his new molecule to reproduce. Although it is not self-replicating, so cannot be considered alive, it may point to the creation of simple, artificial biological systems.

Dr Benner reckons that developing such synthetic biologies would broaden the vision of exobiologists by giving them alternatives to compare with the only natural system now available for examination. That may help them distinguish what is essential for life from the accidents of life on Earth.

This is not an idle distinction. The results of experiments by the *Viking* missions to Mars in 1976 initially met the mission scientists' criteria for the detection of life. These days, though, they are interpreted as having been caused by non-biological chemical reactions. More recently, some students of Mars have concluded that plumes of methane emerging from the planet's surface are geological rather than biological in origin, whereas others argue the opposite.

Nor, according to Paul Davies of Arizona State University, may it be necessary to look to far-distant planets to find aliens. He thinks that living things with an origin (and, therefore, biochemistry) independent of the one that resulted in humans may exist in a "shadow biosphere" on Earth itself.

Tiny life

Most organisms, Dr Davies points out, can be seen only under a microscope, and only an infinitesimal fraction of such microbes have been investigated by researchers. Dr Davies speculates that some microbes may use different nucleotides to the familiar four of DNA and he is urging biologists to scour inhospitable-looking places such as hydrothermal ocean vents and contaminated lakes to see whether some of the life that exists there takes such an unfamiliar form.

It will be a tricky task. Even species of bacteria that belong to the "normal" tree of life are often difficult to culture in the laboratory, which is one reason their study has been neglected. But that does not mean it is not worth looking, for if such a shadow biosphere does exist, it means life has got going on Earth more than once. That would suggest the process is easy, and encourage the hunt for aliens elsewhere. It is to be hoped, though, that if such aliens do turn up they do not spend their lives composing moving poetry and waging war on the rest of the universe.

Dog breeds

The long and the short and the tall

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What, genetically, distinguishes one breed of dog from another is now becoming apparent

A DOG may be man's best friend. But man is not always a dog's. Over the centuries selective breeding has pulled at the canine body shape to produce what is often a grotesque distortion of the underlying wolf. Indeed, some of these distortions are, when found in people, regarded as pathologies.

Dog breeding does, though, offer a chance to those who would like to understand how body shape is controlled. The ancestry of pedigree pooches is well recorded, their generation time is short and their litter size reasonably large, so there is plenty of material to work with. Moreover, breeds are, by definition, inbred, and this simplifies genetic analysis. Those such as Elaine Ostrander, of America's National Human Genome Research Institute, who wish to identify the genetic basis of the features of particular pedigrees thus have an ideal experimental animal.

Dr Ostrander has already used dogs to track down the genes behind certain cancers that the species shares with people, and to work out the dog family tree. At the AAAS she described her search for the genes controlling three of the most important features of a breed: its size, its hair and the length of its legs.

To investigate size, she looked at a breed called the Portuguese water dog. There are about 10,000 of these animals in North America. All of them are descended from an original population of just 30 that was introduced half a century ago. The size of water dogs, she found, is governed mainly by variations in a gene called insulin-like growth-factor 1—and that is probably true of other breeds as well.

Short legs, a phenomenon known as chondrodysplasia, are characteristic of many dog breeds, perhaps most famously dachshunds and corgis. In people the condition is known vulgarly as dwarfism. Dr Ostrander's work showed that in dogs it is caused by the reactivation of a "dead" version of a gene involved in the regulation of growth. Chromosomes are littered with such non-functional genes; they are the result of mutations favoured by natural selection at some point in the past. Here the gene in question has been reactivated by the arrival within it of what is known as a LINE-1 element. This is a piece of DNA that can jump about from place to place within a genome, sometimes causing havoc as it does so.

Woof, woof

Dachshunds also featured in her third example—the genetics of dog-hair. Dog coats come in three forms: smooth (ie, short), long and wiry. Some dogs also have what fanciers refer to as "furniture", notably moustaches. Dr Ostrander found that 80% of the variation between breeds in coat form and furniture was explained by differences in just three genes. Different combinations of these result in different mixtures of coat and furniture.

The upshots of this work are twofold. One is to show that a lot of variety can be caused by only a little genetic variation. Many dog breeds look more different from one another than do the members of groups of real, natural species, so speciation may not be particularly difficult. The second upshot is that dogs may cast light on the condition of human chondrodysplasics and thus prove, once again, what good friends they are to man.

Women's literature in America

A paean to the female pen

Feb 19th 2009
From The Economist print edition

Illustration by Daniel Pudles

American women writers gathered together for the first time

IT IS hard to think of anyone better placed to write the first comprehensive history of American women's literature than Elaine Showalter. One of the founders of feminist literary criticism in America and Princeton University's former professor of English literature, she mixes academic respect with the common touch; she has been a television critic for *People* magazine and has a passion for campus novels, both serious and satirical.

A Jury of Her Peers: American Women Writers from Anne Bradstreet to Annie Proulx
By Elaine Showalter

Knopf; 608 pages; $30

Buy it at
Amazon.com
Amazon.co.uk

Ms Showalter's 18 previous academic works include "A Literature of Their Own: British Women Novelists from Brontë to Lessing", which came out in 1977 and has since become a classic. Now, turning her attention to her own native tradition, she has produced a magisterially wide-ranging survey, which stretches from the time of the Pilgrim Fathers to the present.

Her new book is named after a short story by Susan Gaspell, published in 1917, about a sensational murder trial. A downtrodden farmer's wife from Iowa is accused of murdering her husband. While the sheriff's men miss the proof of her guilt, their more perceptive wives immediately spot what has actually been going on in the bleak farmhouse. Concluding that the wife was driven mad by domestic abuse, they plot to make absolutely sure of her acquittal by secretly destroying the evidence: the patriarchal legal system, they believe, is not fit to judge a woman.

Ms Showalter does not attempt to unravel the intractable moral and legal conundrums raised by this unsettling parable, but she uses it as a metaphor to ask questions about literary judgment. Certainly, in the early 20th century, when literature was being defined as an academic subject, establishment male critics who wanted to make American literature "more energetic and masculine" actively attempted to exclude female writers from the canon. In the 1970s, when Ms Showalter herself started writing about women's literature, many critics thought they had to counter this trend with feminist polemic. In this

book, however, Ms Showalter's admirable aim is less pugnacious: to rescue forgotten works for a general audience, but not to shirk from making judgments (robustly dispensed, for example, towards the "unreadable, self-indulgent and excruciatingly boring" Gertrude Stein). All the writers discussed here are interesting from an historical viewpoint, but only some reach the peaks of genius.

One perennial factor for women writers, according to Ms Showalter, is "how they reconciled their public selves with their private lives". Unlike more abstract forms of criticism, which seem to place the work of art in a vacuum, Ms Showalter's is grounded in the lived lives of her subjects, for whom she provides vibrant biographical sketches. This serves to counter Romantic (and, some would say, ultimately male) myths about the self-sufficiency of art, thus offering a subtle statement of her own feminist aesthetic.

From the earliest period, there seem to have been exceptional women who really were capable of having it all, such as Anne Bradstreet, a prolific 17th-century poet, who had eight children and a happy marriage, as well as critical renown. Others were pushed into writing by circumstance: Mary Rowlandson, who was captured and held hostage by native Americans in 1675, later described her experiences in a vivid account that was part anthropology (her captors' alarming diet included tortoises and horses' ears) and part adventure story.

Race is as dominant a theme as gender for Ms Showalter's project. So she charts the tradition not only of African-American women writers, from Phillis Wheatley, an 18th-century poet, to the Nobel-prize-winning Toni Morrison, but also of white women who wrote on slavery. Pre-eminent among these was Harriet Beecher Stowe. Both Wheatley (who thanked God in heroic couplets for bringing her as a slave to America and Christianity) and the anti-slavery activist Stowe, whose "Uncle Tom's Cabin" depicts the lives of African-American slaves, have been accused of racism. Ms Showalter instead treads a careful line, seeking primarily to appreciate their literary achievements in the cultural context of their times.

The most striking aspect of Ms Showalter's survey is that it is not a history of inevitable progress. Indeed, the mid-19th-century literary marketplace was more dominated by women writers than any period before or since. Marriage and motherhood did not prevent Stowe—for whose exceptional literary craft Ms Showalter makes a powerful case—from achieving unparalleled commercial success and political influence. It is later that female writers begin to feel routinely, sometimes suicidally, trapped by their womanhood. Modernism, with its macho ideal of the artist, seems to have provided a particularly hostile environment.

Ms Showalter ends on an upbeat note, suggesting that women writing today are free from sexual prejudice. One warning, though: given that her overall narrative suggests that female literary status has been subject to historical ups and downs, one cannot assume women's writing will always be seen in the same light.

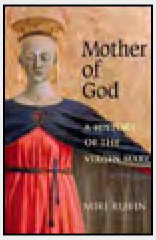
A Jury of Her Peers: American Women Writers from Anne Bradstreet to Annie Proulx.
By Elaine Showalter.
Knopf; 608 pages; $30

Virgin Mary

Mother of God

Feb 19th 2009
From The Economist print edition

Mother of God: A History of the Virgin Mary
By Miri Rubin



Allen Lane; 400 pages; £30. To be published in America by Yale University Press at the end of next month

Buy it at
Amazon.com
Amazon.co.uk

ONE subtle but important difference between the Christian west and the Christian east concerns the way in which the Virgin Mary is conceived (in more than one sense) and depicted. According to Sir Patrick Leigh Fermor, an English writer who lives in Greece, the eastern Mary "has the austere aloofness of an oriental empress…calm, unreal, hieratic", while in the medieval west her statues seem "almost to woo her devotees…at worst there is a hint of an ogle".

Amateur polymaths can allow themselves such sweeping observations. As a scholar of medieval history, Miri Rubin has no such luxury; every twist of her account of Mary's veneration over the past 2,000 years has to be carefully footnoted. And on balance, her enormously ambitious project succeeds; as a sort of encyclopedia of Mariolatry, this commendably readable work will long serve as a reference point for every investigator of this subject, professional or otherwise, and inspire many of them to delve much deeper.

As Ms Rubin, a professor at London University, successfully shows, it is very nearly true to say that the story of Mary's cult simply *is* the history of Christianity, and hence absolutely central to the narrative of European and Christian civilisation. By studying the different ways in which Mary was described, hymned and painted in medieval Italy, one can also describe Europe's beginnings as a great political and commercial enterprise. Her absence was a defining feature of the colder, more rational world that emerged in the Protestant north. And in the colonial era, above all in Latin America, she metamorphosed seamlessly from conquerors' champion to helper of the oppressed—long before any of the founders of modern literary theory had come up with fancy ideas about shifting metaphors and "floating signifiers".

When describing the late medieval era—which was her first academic love—Ms Rubin draws on the nuances of social and economic history as well as art scholarship to produce a tableau as rich as any old-master crowd scene. Given the relative paucity of sources, her account of the first Christian millennium is bare-boned by comparison, concentrating on theology and imperial history. She describes the Byzantine empire's appropriation of the Mother of God as protectress—of the city of Constantinople and its rulers—and the intricate metaphysical groundwork which made that change possible.

The faith's official theology, after wrestling with the different senses in which Christ was human and divine, had crystallised with the pronouncement in the early fifth century that Mary was Theotokos, the Mother of God: the person whose body was the miraculous locus of a unique cosmic event, the coming together of the Creator and the created, physical world. Once this principle had been established, every deviation from it, every current of thought that called into question the double nature—divine and human—of Christ, could be presented as a direct insult to his mother; and theological arguments duly became more personal.

For all the differences between the first Christian millennium and the second, a common theme in discourse about Mary was polemic against the Jews, who especially in Byzantium were often regarded as the "other" in relation to which Christianity must define itself. In some contexts, the word "Jew" seems to have been used almost as a generic term for one who failed to give due honour to Jesus Christ and his mother. And as Ms Rubin notes, the early Christian era also saw plenty of Jewish counter-polemic, mocking the story of Mary's virginity and suggesting that she was an adulteress.

As a counterweight to the lamentable history of Christian-Jewish sparring, Ms Rubin might have said a bit more about the latest insights into the apparently Jewish roots of the Christian feasts which are ostensibly devoted to the Mother of God. Also, having described the carefully constructed theological edifice of early Christianity, Ms Rubin could perhaps have said more about the ways in which—to eastern

Christian eyes—the medieval west seemed to cut adrift from that structure, with effects that were palpable in art history as well as culture, politics and perhaps even social history. (There are social anthropologists, for example, who contrast the Catholic emphasis on Mary's virginity with the Orthodox Christian *Panayia*—all-holy one—who seems more like an archetype of motherhood and protection of the family.)

To the eyes of the Christian east, the western Madonna often seems to be rather a shallow and sentimental figure because her theological role as agent and locus of the Incarnation has been forgotten or blurred. Travel writers, relying purely on intuition, can pick up that point; it would be wonderful if scholars—labouring under a much tougher set of constraints—could also find some way of expressing and explaining that difference.

Mother of God: A History of the Virgin Mary.
By Miri Rubin.
Allen Lane; 400 pages; £30. To be published in America by Yale University Press at the end of next month

Fiction from Pakistan

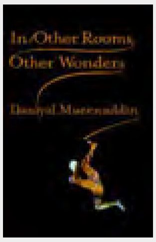
Poignant Punjab

Feb 19th 2009
From The Economist print edition

IN PAKISTAN life is shaped as much by who you know as what you do. In this remarkable debut, a range of characters rich in practical intelligence demonstrate the importance of influence. An electrician burdened with 12 daughters persuades his employer to give him a motorcycle; a servant sleeps her way into maintaining her position in a Lahore household; a down-at-heel woman pleads for a post with a distant rich relation.

Each is practising *safarish* (recommendation), manipulating the social networks that determine how you rise or fall. There is little grand politics here and no airport fiction fare about terrorists or tribal areas. Each of these eight interconnected stories illustrates elements of Pakistan that are familiar to those who live there, though rarely well understood outside. The grand feudals, with their estates, impeccable manners and bootlegged Scotch, see their fortunes changing. A new generation is rising to challenge them, enriched by business and politics as much as land. The struggle to survive and the risks of failure are all described. It is too easy to tumble into the brothels of Lahore or become one of the many "sparrows" begging on the streets.

In Other Rooms, Other Wonders
By Daniyal Mueenuddin



Norton; 249 pages; $23.95.To be published in Britain by Bloomsbury in April

These are also stories about women and men, and sometimes love. Lily, a partying socialite in Islamabad, surprises herself when she falls for Murad, a gentleman-farmer whose overwhelming sense of purpose captures her heart. After being injured in a car accident, Lily had vowed to change her way of life. But soon after marrying Murad she falls back into her old ways, badly disappointing herself in the process.

Daniyal Mueenuddin, who was brought up in Lahore and in Elroy, Wisconsin, has a talent for switching voices. He is as adept at capturing the considered musings of a judge in his Pakistani home town as the blunt instructions of a landlord's sidekick in rural Punjab. Mr Mueenuddin used to live in New York, where he practised law, before returning to Pakistan to farm—and write. He has reaped a good harvest. Two of his stories have already been published in the *New Yorker* and one in *Granta*, and his writing has gathered plaudits from Mohsin Hamid and Salman Rushdie. This collection is all about how Pakistan works: a poignant picture of Punjabi life from top to bottom.

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By Daniyal Mueenuddin.
Norton; 249 pages; $23.95.To be published in Britain by Bloomsbury in April

Oral history in China

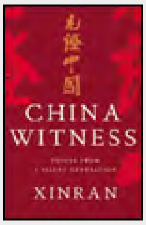
Tales of old

Feb 19th 2009
From The Economist print edition

EVER since Jung Chang's 1991 book, "Wild Swans", became an international bestseller, writers about China have understood that it is people's personal stories that bring to life the difficult history of this country. "China Witness" is a new addition to the genre.

AFP

China Witness: Voices from a Silent Generation
By Xinran



Pantheon; 448 pages; $28.95. Chatto & Windus; £20

Buy it at
Amazon.com
Amazon.co.uk

The author, Xinran Xue, who uses the name Xinran as a *nom de plume*, is an old hand. From 1988 to 1997 she was one of the country's most popular broadcasters. In a state-run medium dominated by propaganda, she invited women to pick up the telephone and tell their life stories on air. A deluge of personal revelation followed, and the programme earned a huge following. In 1997 Xinran moved to England, where she met and later married Jung Chang's then literary agent. He encouraged her to write "The Good Women of China", a collection of stories, based on those radio confessions, that revealed the raw misery of the lives of many women, especially in the countryside.

In "China Witness", which was published in Britain last October and is just coming out in America, Xinran turns to the people she terms the "grandparents" of China. She is afraid of what will be lost when those who have lived through China's modern history inevitably grow old and die. The younger generation knows very little about their elders' experience, in particular about what they endured and sacrificed in the name of Mao Zedong's great experiment. Several of Xinran's interviewees tell her not just that the young do not know about the past, but they do not particularly want to know. Politically sensitive issues are rarely discussed.

Although "China Witness" lacks the stark novelty of "The Good Women of China", and occasionally lapses into slightly sentimental language, it is still an engaging and affecting book. The reader meets a 75-year-old man who joined the police in 1949 and left in disgust at corruption in the 1980s, losing most of his retirement benefits in the process. He has not ventured outside his tiny house for years because his wife is in a coma, and he does not want her to wake up and find him gone.

Xinran speaks also to a woman who runs a stall mending shoes. She and her husband, who repairs bicycles, live in such poverty that they use old tyres as seats. But they have sent both their children to good universities and on to postgraduate study. The woman remembers her own fierce academic ambition and how the Cultural Revolution put an end to it. Now she is living through her children, and her own needs seem of little concern to her.

The author wants to restore China's pride in itself and she clutches at straws of hope. When she reads in a newspaper about a legal reform that requires all death sentences to be ratified by the supreme court, she eagerly telephones the former police officer, expecting that he will share her enthusiasm for what she sees as an important step in the right direction. Instead, he tells her, "These are just words on paper, miles away from the heads of the people who deal with the cases."

China Witness: Voices from a Silent Generation.
By Xinran.
Pantheon; 448 pages; $28.95. Chatto & Windus; £20

"The Winter's Tale"

Crackling wire of menace

Feb 19th 2009 | NEW YORK AND WASHINGTON, DC
From The Economist print edition

Two contrasting productions

HOW can Shakespeare's "The Winter's Tale" be credibly staged? The play features a 16-year entr'acte, either a resurrection or a sadistically prolonged imprisonment, inexplicably sudden emotional shifts and, of course, the most famous stage direction in dramatic history: "Exit, pursued by a bear." Characters within the play even comment on its plot proceeding "like an old tale still, that will have matter to rehearse though credit be asleep and not an ear open".

Both Blake Robison, director of the production now running at the Folger Elizabethan Theatre in Washington, DC, and Sam Mendes, who directs the Bridge Project's production at the Brooklyn Academy of Music in New York, emphasise this aspect by opening their productions with the actor who plays the unfortunate Mamillius, the boy-prince who dies of grief, reading from a book of fairy tales. Mr Robison uses this opening as a way to lighten the play: if it is all a fairy tale, then nothing really matters. His production is inconsequential and unmoving as a result.

A crackling wire of menace, by contrast, runs through Mr Mendes's production, as it should. Torturing stepsisters and the ravenous wolf are the stuff of nightmares; fairy tales are frippery without that frisson. The centre of this particular menace—and indeed of this production—is Simon Russell Beale's outstanding interpretation of Leontes, the Sicilian king who becomes convinced that his wife Hermione has betrayed him with his friend Polixenes, the king of Bohemia. (Harold Bloom memorably called Leontes "an Othello who is his own Iago"). Mr Beale plays Leontes as a bluff but insecure and dream-haunted man who loses his mind. His descent into madness is rapid but not sudden, and his lunacy seems inevitable.

It helps that Mr Beale's Leontes is grey, podgy and homely, whereas Josh Hamilton's Polixenes is slender and handsome and Hermione, played by Rebecca Hall, has a jangly, coltish beauty that matches Mr Hamilton's suavity all too well. It helps, too, that Mr Beale has an uncanny ability to connect with the audience, with neither vanity nor histrionics; there is something eerily and painfully immediate to his Leontes. His unspooling performance is complemented by Sinead Cusack's Paulina, a model of sanity and control. Too often directors turn Paulina into a hectoring harridan; Ms Cusack instead is steely but compassionate, and her manifest devotion to Leontes helps make him all the more pitiable and lovable.

The play's mood lightens when the action moves to Bohemia, which Mr Mendes depicts as a fantasia in the American south. In the sheepshearing scene, Perdita, daughter of Leontes and Hermione, dresses as Lady Liberty, and Ethan Hawke portrays Autolycus as a canny, sneering, but irresistibly charming troubadour of the Townes Van Zandt variety. This change in setting—Sicilia is sombre, candlelit and chilly—helps explain the mixture of English and American accents among the cast, which might otherwise jar. Mr Mendes's direction is imaginative and sure-handed right through to the final scene, when a single gesture from Ms Hall's Hermione makes you wonder whether you have seen a fairy-tale reconciliation, or something far more unsettling.

Blake Robison's "The Winter's Tale" is at the Folger Elizabethan Theatre, Washington, DC, until March 8th. Sam Mendes's production is at the Brooklyn Academy of Music, New York, also until March 8th. It then travels to Singapore, Auckland, Madrid, Recklinghausen, London and Athens.

New exhibitions

Silken splendour

Feb 19th 2009
From The Economist print edition

Two shows depict wealth, power and patronage

IN 1598, the Iranian emperor, Shah Abbas, moved his capital to Isfahan. Eager both to demonstrate and to enhance his power, he set about enlarging and embellishing it in an extravagant fashion. Isfahan soon became one of the most beautiful and cosmopolitan of cities, where foreigners and non-Muslims alike were welcomed. In the same year it became a capital, Robert Shirley, an 18-year-old Englishman, arrived in Iran. The ambitions of these two men, one the ruler of his country, the other a junior partner in a team of English soldier-adventurers, soon intersected.

Within a decade, Shirley had married a Circassian Christian, Teresia, and set off with her to Europe on a series of diplomatic missions in the service of the shah. Their purpose was twofold: Abbas hoped to gain allies for his struggles against the encroaching Ottoman Turks and also to build up Iran’s silk trade. The Shirleys’ sales efforts were helped by the splendour of their dress, advertising the most opulent Iranian fabrics. His outfit, a gift from Shah Abbas, was like an Isfahan grandee’s ceremonial uniform, topped by a turban bigger than his head. Her gowns were in the fashion favoured by her English contemporaries.

In a curious coincidence the dazzling effect they created in Poland and Germany, the Vatican and Spain can be seen in two portraits in “Shah Abbas: The Making of Iran”, a new exhibition at the British Museum, and in two others in “Van Dyck and Britain”, at Tate Britain. This has proved to be all to the good. Each set of paintings adds to the enjoyment of the exhibition in which it hangs. The Van Dyck Shirleys capture the enchantment with exoticism that seems almost as emblematic of upper-class English life as the portraits of lords and dogs on view. In turn, the extraordinary detail of the anonymous Shirley portraits at the British Museum illustrates the superb quality and imaginative designs of the best Iranian silks.

Seeing all four paintings allows the viewer to fill in gaps. The Van Dycks show how enticing the Shirleys must have looked to the English whose support they were after. The anonymous portraits, in turn, reveal why Iranian silks were so sought after in the West. Van Dyck was able to get across the luxuriousness, romance and richness of the silken clothes without occupying himself with reproducing them in detail. Look where you will, the point is made, for the silks were crucially important. Silk was exchanged for gold and silver with which Shah Abbas paid for Isfahan. It paid, also, for the lavish gifts he gave to Iran’s most holy Shia shrines, the foundation on which a unified Iran was built.

Alison Des Forges

Feb 19th 2009
From The Economist print edition

Human Rights Watch

Alison Des Forges, a witness to genocide, died on February 12th, aged 66

TWO plane crashes bookmarked Alison Des Forges's life. The first was nearly 15 years ago, when a luxury jet carrying two African presidents was shot down by missiles over Rwanda. The second was last week, when a cramped commuter plane crashed in icy weather near Buffalo, New York, killing 50 people. The first crash served as the pretext for the swiftest genocide in history. The second silenced its most dogged witness, a tiny American lady with silver hair.

On April 6th 1994, Mrs Des Forges was at home in Buffalo. The presidents of Rwanda and Burundi were assassinated at 8.20pm that day, which was lunchtime in Buffalo. Twenty minutes later, a friend telephoned Mrs Des Forges from Kigali, the Rwandan capital. "This is it. We're finished," said Monique Mujawamariya, a fellow human-rights monitor.

Mrs Des Forges called her every half-hour, late into the night. She heard her describe steadily more alarming scenes—militiamen going from house to house, pulling people out and killing them. Eventually, they came to Ms Mujawamariya's door. Mrs Des Forges told her to pass the telephone to the killers. She would pretend to be from the White House, she said, and warn them off. "No, that won't work," said Ms Mujawamariya. Then she added: "Please take care of my children. I don't want you to hear this." And she hung up.

From that moment on, Mrs Des Forges made a lot of noise. She was steeped in Rwanda's turbulent history, having written her doctoral thesis about it in 1972. And she had a better sense than most of the evil that was brewing two decades later. She had spent years in Rwanda, investigating political violence for Human Rights Watch. She knew that a 1993 peace accord between the Hutu-dominated government and a Tutsi-led rebel group, the Rwandan Patriotic Front (RPF), was written in water, and that Hutu military leaders were mulling mass killings to avoid sharing power. She knew something terrible was afoot.

Shouting at the deaf

She made calls, sent faxes and frantically gathered information. By April 17th she was convinced that a full-blown genocide was under way. She was one of the first outsiders to say so. But everyone who mattered ignored her. Africa specialists at the State Department wept with her when she described what was going on, but who listens to Africa specialists? The top bureaucrats at the UN were concerned mostly with evacuating foreigners. President Bill Clinton was anxious to avoid another Somalia (where, the previous year, 18 American soldiers had been killed during a humanitarian mission). Mrs Des Forges could not even persuade the Pentagon to jam the radio broadcasts that co-ordinated the slaughter. It would have cost too much.

The genocide ended when the RPF rebels overthrew the Hutu government and seized power. For the next four years Mrs Des Forges led a team of researchers to dig up the facts. She then wrote the definitive account: nearly 800 pages of scrupulously footnoted horror. Future historians will depend on it. Her testimony helped put several of the perpetrators behind bars. And she made it impossible to argue, as many did at the time, that the genocide was a spontaneous explosion of ancient tribal hatred. She read the plans. She saw the receipts for half a million machetes.

In some ways, she was old-fashioned. Whereas other human-rights activists fuss about an ever-lengthening list of socio-economic “rights” (subsidised housing, fair trade, and so forth), Mrs Des Forges stuck to the basics, such as the right not to be murdered. She took extraordinary risks, rushing to the scenes of massacres and questioning killers when their blades were barely dry. She left out none of the ghastly details: the wives forced to bury their husbands before being raped; the baby thrown alive into a latrine.

She never went further than the facts allowed. Others might speculate that the genocide claimed 800,000 victims, or a million. She stuck with half a million, because she could substantiate it. Others assumed that if the genocidal Hutu regime were the bad guys, then the Tutsi rebels who overthrew them must be the good guys. Not so fast, said Mrs Des Forges: only one side was guilty of genocide, but both committed war crimes. The RPF killed perhaps 25,000 people in 1994, she reckoned.

Mrs Des Forges’s integrity made her unpopular with the RPF regime that still rules Rwanda. Last year, after she wrote a balanced but critical report about the Rwandan justice system, she was barred from the country. Shortly before she died, she spoke up for an exiled academic she thought was unjustly accused of taking part in the genocide. She never seemed to rest. A report she edited about violence in Congo was published posthumously.

What drove her? One story is revealing. In Burundi, Rwanda’s neighbour, tens of thousands of civilians were slaughtered in 1993. The Western media barely noticed. Hutu officers in Rwanda concluded that they could do the same thing, and no one would give a damn. Mrs Des Forges wanted to document such atrocities so meticulously, and publicise them so persistently, that people would have to give a damn. Her book was called, after a killer’s cry, “Leave None to Tell the Story”. She knew that story-telling matters.

Overview

Feb 19th 2009
From The Economist print edition

Japan's GDP tumbled by 3.3% in the fourth quarter of last year. The **euro area's** contracted by 1.5%. The GDP of OECD countries as a group fell by 1.5%, according to the think-tank. This is the biggest drop since the OECD started to keep such records in 1960.

Housing starts in **America** fell at an annualised rate of 16.8% in January. They were 56.2% lower than a year earlier. New homes were being built at an annualised rate of 466,000, the lowest on record. Construction is being held back by a glut of unsold properties, which are largely the product of recent foreclosures.

Mexico's industrial output was 6.7% lower in December than a year earlier. Car production plunged by 51% in January, according to the country's automotive-industry association. Cars and car parts make up about a fifth of Mexico's manufactures.

Asia's export-driven economies continued to be battered by the fall in overseas demand. **Taiwan's economy** shrank by 8.4% in the year to the fourth quarter. The fall in output was the largest since records began to be kept in 1952, and prompted the country's central bank to cut interest rates by 0.25 percentage points, to 1.25%, on February 18th. Exports from **Singapore** fell by 34.8% in the year to January.

An increase in purchases by Chinese steelmakers led to a rise in **India's** exports of iron ore, to 13.9m tonnes in January from 11.5m tonnes a year earlier.

Output, prices and jobs

Feb 19th 2009
From The Economist print edition

Output, prices and jobs

% change on year ago

	Gross domestic product				Industrial production	Consumer prices			Unemployment
	latest	qtr*	2008†	2009†	latest	latest	year ago	2008†	rate‡, %
United States	−0.2 Q4	−3.8	+1.2	−2.0	−10.0 Jan	+0.1 Dec	+4.1	+3.8	7.6 Jan
Japan	−4.6 Q4	−12.7	−0.2	−3.2	−20.8 Dec	+0.4 Dec	+0.7	+1.4	4.4 Dec
China	+6.8 Q4	na	+9.0	+6.0	+5.7 Dec	+1.0 Jan	+7.1	+5.9	9.0 2008
Britain	−1.8 Q4	−5.9	+0.7	−2.6	−9.3 Dec	+3.0 Jan§	+2.2	+3.6	6.3 Dec††
Canada	+0.5 Q3	+1.3	+0.5	−0.7	−5.1 Nov	+1.2 Dec	+2.4	+2.4	7.2 Jan
Euro area	−1.2 Q4	−5.7	+0.8	−2.1	−12.0 Dec	+1.1 Jan	+3.2	+3.1	8.0 Dec
Austria	+0.5 Q4	−0.8	+1.4	−1.3	+0.7 Nov	+1.3 Dec	+3.6	+3.2	3.9 Dec
Belgium	+1.3 Q3	+0.4	+1.3	−1.3	−11.6 Nov	+2.3 Jan	+3.5	+4.5	11.1 Jan‡‡
France	−1.0 Q4	−4.6	+0.7	−1.7	−11.1 Dec	+1.0 Dec	+2.6	+2.8	8.1 Dec
Germany	−1.6 Q4	−8.2	+1.1	−2.5	−12.0 Dec	+0.9 Jan	+2.8	+2.6	7.8 Jan
Greece	+2.6 Q4	+0.7	+1.1	−1.8	−8.7 Dec	+1.8 Jan	+3.9	+4.1	7.4 Oct
Italy	−2.6 Q4	−7.1	−0.6	−2.3	−14.3 Dec	+1.6 Jan	+3.0	+3.3	6.7 Q3
Netherlands	−0.6 Q4	−3.4	+1.8	−1.6	−13.3 Dec	+1.9 Jan	+2.0	+2.3	3.9 Jan††
Spain	−0.7 Q4	−3.8	+1.1	−2.3	−15.4 Dec	+0.8 Jan	+4.3	+3.9	14.4 Dec
Czech Republic	+4.2 Q3	+3.8	+4.0	−1.4	−14.6 Dec	+2.2 Jan	+7.5	+6.3	6.8 Jan
Denmark	−1.2 Q3	−1.9	−0.6	−1.7	−5.4 Dec	+1.8 Jan	+2.9	+3.5	2.1 Dec
Hungary	+0.8 Q3	−0.3	+0.8	−3.0	−23.3 Dec	+3.5 Dec	+7.4	+6.2	8.0 Dec††
Norway	+0.8 Q4	+5.6	+1.5	−1.0	+3.7 Dec	+2.2 Jan	+3.7	+3.8	2.9 Nov***
Poland	+4.8 Q3	na	+5.1	+2.9	−4.4 Dec	+3.1 Jan	+4.0	+4.3	9.5 Dec‡‡
Russia	+1.1 Q4	na	+6.0	+1.0	−10.8 Dec	+13.4 Jan	+12.6	+14.1	8.1 Jan‡‡
Sweden	nil Q3	−0.4	+0.6	−1.0	−20.3 Dec	+1.3 Jan	+3.2	+3.4	7.3 Jan‡‡
Switzerland	+1.7 Q3	+0.1	+1.8	−1.0	+0.7 Q3	+0.1 Jan	+2.4	+2.3	2.9 Jan
Turkey	+0.5 Q3	na	+1.5	−1.5	−17.6 Dec	+9.5 Jan	+8.2	+10.4	10.3 Q3‡‡
Australia	+1.9 Q3	+0.3	+2.2	+0.3	+3.8 Q3	+3.7 Q4	+3.0	+4.4	4.8 Jan
Hong Kong	+1.7 Q3	−2.0	+3.1	−4.7	−6.7 Q3	+2.1 Dec	+3.8	+4.3	4.6 Jan††
India	+7.6 Q3	na	+5.3	+5.0	−2.0 Dec	+9.7 Dec	+5.5	+8.2	6.8 2008
Indonesia	+5.2 Q4	na	+6.1	+1.9	−2.8 Dec	+9.2 Jan	+5.6	+10.3	8.4 Aug
Malaysia	+4.7 Q3	na	+5.1	−0.3	−15.6 Dec	+4.4 Dec	+2.4	+5.5	3.1 Q3
Pakistan	+5.8 2008**	na	+6.0	+1.2	−1.2 Nov	+20.5 Jan	+11.9	+20.3	5.6 2007
Singapore	−3.7 Q4	−16.9	+1.2	−7.2	−13.5 Dec	+4.3 Dec	+4.4	+6.5	2.6 Q4
South Korea	−3.4 Q4	−20.8	+2.6	−5.9	−18.6 Dec	+3.7 Jan	+3.9	+4.7	3.3 Jan
Taiwan	−8.4 Q4	na	+1.8	−3.5	−32.3 Dec	+1.6 Jan	+2.9	+3.5	5.0 Dec
Thailand	+4.0 Q3	+2.3	+3.0	−1.8	−18.8 Dec	−0.4 Jan	+4.3	+5.5	1.1 Sep
Argentina	+6.2 Q3	+5.4	+6.0	−2.7	−7.2 Nov	+6.8 Jan	+8.2	+8.6	7.3 Q4‡‡
Brazil	+6.8 Q3	+7.4	+5.3	+1.6	−14.5 Dec	+5.8 Jan	+4.6	+5.7	6.8 Dec‡‡
Chile	+4.8 Q3	−0.2	+3.5	+1.0	−3.7 Dec	+6.3 Jan	+7.5	+8.7	7.5 Dec††‡‡
Colombia	+3.1 Q3	+2.9	+2.7	−0.5	−13.3 Nov	+7.2 Jan	+6.0	+7.0	10.8 Nov‡‡
Mexico	+1.6 Q3	+2.6	+1.5	−1.8	−6.7 Dec	+6.3 Jan	+3.7	+5.1	4.3 Dec‡‡
Venezuela	+4.6 Q3	na	+4.9	−3.0	+2.7 Sep	+30.7 Jan	+24.1	+30.4	6.3 Q4‡‡
Egypt	+5.9 Q3	na	+7.2	+4.9	+7.3 Q3	+14.4 Jan	+10.5	+18.3	8.6 Q3‡‡
Israel	+5.1 Q3	+2.3	+4.1	+0.4	+0.3 Nov	+3.3 Jan	+3.5	+4.6	5.9 Q3
Saudi Arabia	+3.5 2007	na	+4.2	+0.4	na	+9.5 Nov	+4.8	+9.4	na
South Africa	+2.9 Q3	+0.2	+3.0	+1.0	−7.0 Dec	+9.5 Dec	+9.0	+11.3	23.2 Sep‡‡
MORE COUNTRIES Data for the countries below are not provided in printed editions of *The Economist*									
Estonia	−9.4 Q4	na	−2.8	−5.0	−20.7 Dec	+4.1 Jan	+11.0	+10.4	8.3 Nov
Finland	+1.3 Q3	+0.4	+1.6	−1.3	−15.6 Dec	+2.2 Jan	+3.9	+4.1	6.6 Dec
Iceland	−0.8 Q3	−5.5	−0.5	−9.7	+0.4 2007	+18.6 Jan	+5.8	+13.8	4.8 Dec‡‡
Ireland	+0.1 Q3	+4.7	−2.9	−4.0	−12.3 Dec	−0.1 Jan	+4.3	+4.2	9.2 Jan
Latvia	−10.5 Q4	na	−1.8	−8.0	−14.2 Dec	+9.8 Jan	+15.8	+15.4	9.0 Nov
Lithuania	−1.5 Q4	−9.3	+3.7	−4.8	na	+9.6 Jan	+9.9	+10.9	7.0 Jan‡‡
Luxembourg	−0.3 Q3	−5.5	+0.6	−2.8	−15.9 Nov	+1.1 Dec	+3.4	+3.4	5.0 Dec‡‡
New Zealand	−1.4 Q3	−2.7	−0.9	−3.2	−0.5 Q3	+3.4 Q4	+3.2	+4.0	4.6 Q4
Peru	+5.1 Nov	na	+9.1	+3.1	+5.1 Nov	+6.5 Jan	+4.2	+5.8	8.1 Dec††
Philippines	+4.5 Q4	+4.1	+4.3	−0.5	−6.6 Nov	+7.1 Jan	+4.9	+9.3	6.8 Q4‡‡
Portugal	−2.1 Q4	−7.8	+0.3	−2.0	−11.4 Dec	+0.2 Jan	+2.9	+2.6	7.7 Q3‡‡
Slovakia	+7.0 Q3	na	+6.8	+2.0	−16.7 Dec	+3.7 Jan	+3.8	+4.6	8.4 Dec‡‡
Slovenia	+3.8 Q3	na	+4.0	+0.5	−17.5 Dec	+1.6 Jan	+6.4	+5.7	7.0 Dec‡‡

*% change on previous quarter, annual rate. †*The Economist* poll or Economist Intelligence Unit estimate/forecast. ‡National definitions.- §RPI inflation rate 0.9% in Dec. **Year ending June. ††Latest three months. ‡‡Not seasonally adjusted. ***Centred 3-month average

Sources: National statistics offices and central banks; Thomson Datastream; Reuters; Centre for Monitoring Indian Economy; OECD; ECB

The Economist commodity-price index

Feb 19th 2009
From The Economist print edition

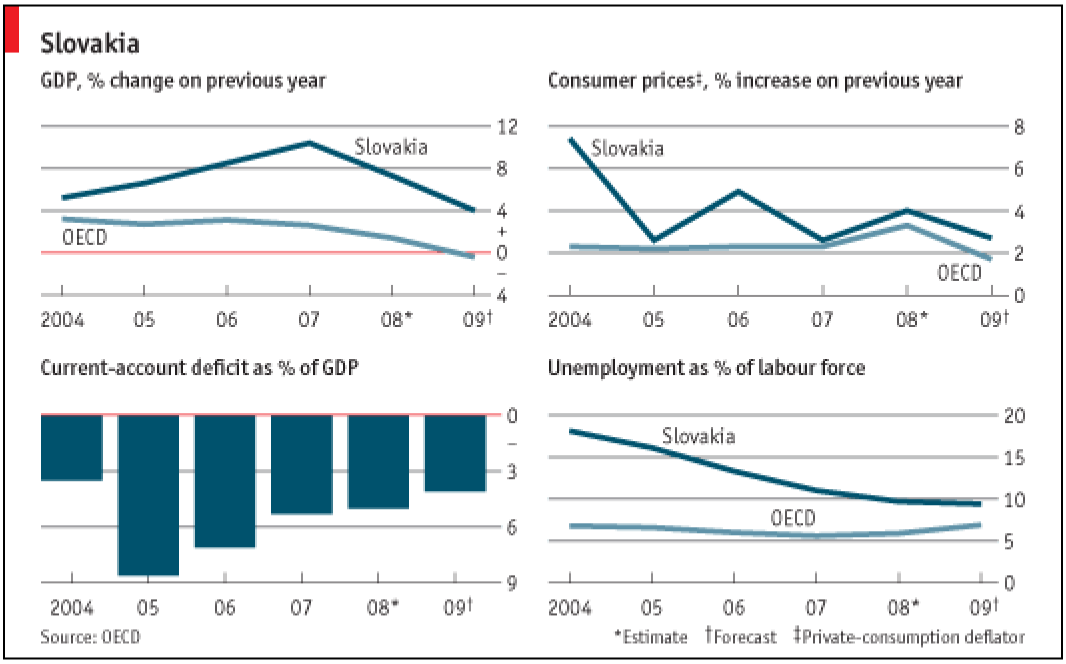
The Economist commodity-price index
2000=100

	Feb 10th	Feb 17th*	% change on one month	% change on one year
Dollar index				
All items	161.3	155.2	-2.3	-38.5
Food	190.0	183.9	-2.0	-26.9
Industrials				
All	124.3	118.1	-2.7	-53.3
Nfa†	114.9	110.6	-3.0	-42.0
Metals	129.4	122.2	-2.5	-57.4
Sterling index				
All items	166.5	165.1	-4.3	-15.8
Euro index				
All items	114.4	114.1	+0.4	-27.8
Gold				
$ per oz	912.70	969.80	+12.5	+4.5
West Texas Intermediate				
$ per barrel	37.87	34.96	-9.3	-64.9

*Provisional †Non-food agriculturals.

Slovakia

Feb 19th 2009
From The Economist print edition



Trade, exchange rates, budget balances and interest rates

Feb 19th 2009
From The Economist print edition

Trade, exchange rates, budget balances and interest rates

	Trade balance*	Current-account balance		Currency units, per $		Budget balance	Interest rates, %	
	latest 12 months, $bn	latest 12 months, $bn	% of GDP 2008†	Feb 18th	year ago	% of GDP 2008†	3-month latest	10-year gov't bonds, latest
United States	−820.6 Dec	−697.9 Q3	−4.6	–	–	−3.2	0.50	2.73
Japan	+36.2 Dec	+156.0 Dec	+3.6	93.6	108	−3.1	0.61	1.25
China	+314.8 Jan	+371.8 2007	+10.2	6.84	7.14	−0.1	1.29	3.16
Britain	−173.0 Dec	−45.6 Q3	−2.2	0.70	0.52	−5.3	2.13	3.38
Canada	+45.8 Dec	+19.2 Q3	+1.0	1.26	1.02	0.3	0.70	2.86
Euro area	−46.4 Dec	−88.9 Nov	−0.4	0.80	0.68	−1.7	1.93	2.97
Austria	−1.5 Nov	+16.8 Q3	+3.1	0.80	0.68	−0.6	1.91	4.31
Belgium	+5.6 Nov	−8.2 Sep	+0.4	0.80	0.68	−0.9	1.94	4.16
France	−79.6 Dec	−56.1 Dec	−1.8	0.80	0.68	−3.2	1.91	3.49
Germany	+264.5 Dec	+237.0 Dec	+6.6	0.80	0.68	0.2	1.91	2.97
Greece	−67.0 Nov	−52.6 Nov	−13.3	0.80	0.68	−3.9	1.91	5.96
Italy	−16.6 Dec	−72.4 Nov	−2.8	0.80	0.68	−2.9	1.91	4.32
Netherlands	+52.7 Dec	+67.6 Q3	+6.9	0.80	0.68	1.0	1.91	3.67
Spain	−149.5 Oct	−164.1 Oct	−9.8	0.80	0.68	−3.3	1.91	4.00
Czech Republic	+4.4 Dec	−6.6 Dec	−3.1	23.1	17.2	−1.5	2.44	4.53
Denmark	+5.6 Dec	+6.0 Dec	+1.0	5.95	5.09	3.3	3.55	3.66
Hungary	nil Dec	−11.3 Q3	−5.6	242	182	−3.4	9.50	11.30
Norway	+76.3 Jan	+86.5 Q3	+18.3	7.04	5.39	19.8	3.53	3.70
Poland	−23.7 Dec	−28.5 Dec	−5.6	3.81	2.44	−1.8	4.70	6.13
Russia	+179.8 Dec	+98.9 Q4	+6.0	36.3	24.6	5.5	13.00	12.44
Sweden	+17.2 Dec	+40.5 Q3	+7.3	8.79	6.37	2.6	0.65	2.86
Switzerland	+19.2 Jan	+40.3 Q3	+8.9	1.18	1.10	0.9	0.50	1.83
Turkey	−69.8 Dec	−41.4 Dec	−5.4	1.70	1.21	−1.8	13.67	7.98‡
Australia	−4.0 Dec	−56.7 Q3	−5.0	1.57	1.09	−1.9	3.05	4.08
Hong Kong	−26.0 Dec	+27.1 Q3	+9.2	7.76	7.80	−2.1	0.78	1.49
India	−114.5 Dec	−28.5 Q3	−3.6	49.9	40.2	−6.0	4.37	7.06
Indonesia	+8.7 Dec	+3.9 Q3	+0.4	11,920	9,190	−1.2	9.90	10.32‡
Malaysia	+42.7 Dec	+38.3 Q3	+11.4	3.66	3.22	−5.1	2.59	3.68‡
Pakistan	−20.9 Jan	−15.6 Q3	−5.5	80.1	62.0	−6.8	13.89	22.68‡
Singapore	+18.4 Dec	+29.2 Q3	+13.5	1.53	1.41	0.8	0.61	1.77
South Korea	−12.6 Jan	−6.4 Dec	−0.7	1,469	946	0.3	2.58	5.41
Taiwan	+6.2 Jan	+28.8 Q3	+4.7	34.6	31.6	−1.7	1.10	1.49
Thailand	+0.2 Dec	−0.2 Dec	−0.1	35.4	32.5	−0.6	2.15	2.90
Argentina	+13.2 Dec	+9.0 Q3	+2.8	3.51	3.15	1.3	14.56	na
Brazil	+23.3 Jan	−28.3 Dec	−1.9	2.36	1.74	−0.7	12.66	6.16‡
Chile	+8.5 Jan	−1.6 Q3	−2.3	597	470	4.5	5.88	3.60‡
Colombia	+2.0 Dec	−5.3 Q3	−2.7	2,561	1,909	−1.4	8.94	7.24‡
Mexico	−16.0 Dec	−11.8 Q3	−1.9	14.7	10.8	−0.1	7.00	8.17
Venezuela	+50.2 Q3	+49.4 Q3	+14.8	5.65	5.00§	−1.1	17.01	6.55‡
Egypt	−25.2 Q3	+0.1 Q3	−0.9	5.56	5.49	−6.8	10.79	4.73‡
Israel	−13.1 Jan	+2.6 Q3	+1.2	4.15	3.63	−2.1	0.64	3.08
Saudi Arabia	+150.8 2007	+95.0 2007	+26.2	3.75	3.75	33.6	1.15	na
South Africa	−10.9 Dec	−23.2 Q3	−7.5	10.3	7.90	0.1	10.05	8.55
MORE COUNTRIES Data for the countries below are not provided in printed editions of *The Economist*								
Estonia	−3.9 Nov	−2.2 Dec	−9.6	12.5	10.7	−2.3	6.73	na
Finland	+10.1 Dec	+6.7 Dec	+3.5	0.80	0.68	4.6	1.88	3.50
Iceland	−0.2 Jan	−5.4 Q3	−17.3	114	67.5	0.3	18.13	na
Ireland	+41.4 Nov	−16.4 Q3	−4.9	0.80	0.68	−6.6	1.91	5.41
Latvia	−6.4 Dec	−4.8 Nov	−14.1	0.56	0.48	−2.7	9.29	na
Lithuania	−7.4 Dec	−6.3 Dec	−12.6	2.76	2.36	−1.0	7.10	na
Luxembourg	−7.8 Nov	+4.0 Q3	na	0.80	0.68	−0.1	1.91	na
New Zealand	−3.8 Dec	−11.6 Q3	−8.1	1.97	1.26	−1.0	3.75	4.55
Peru	+3.2 Dec	−3.0 Q3	−3.8	3.24	2.90	2.1	6.25	na
Philippines	−7.5 Nov	+2.9 Sep	+1.8	47.7	40.8	−0.8	5.25	na
Portugal	−34.4 Nov	−29.3 Nov	−11.5	0.80	0.68	−2.4	1.91	4.55
Slovakia	−0.9 Dec	−6.4 Oct	−6.1	24.0	22.6	−2.3	1.35	3.77
Slovenia	−4.7 Dec	−3.1 Nov	−6.1	0.80	0.68	−0.6	1.91	na

*Merchandise trade only. †*The Economist* poll or Economist Intelligence Unit forecast. ‡Dollar-denominated bonds. §Unofficial exchange rate.
Sources: National statistics offices and central banks; Thomson Datastream; Reuters; JPMorgan; Bank Leumi le-Israel; Centre for Monitoring Indian Economy; Danske Bank; Hong Kong Monetary Authority; Standard Bank Group; UBS; Westpac.

Markets

Feb 19th 2009
From The Economist print edition

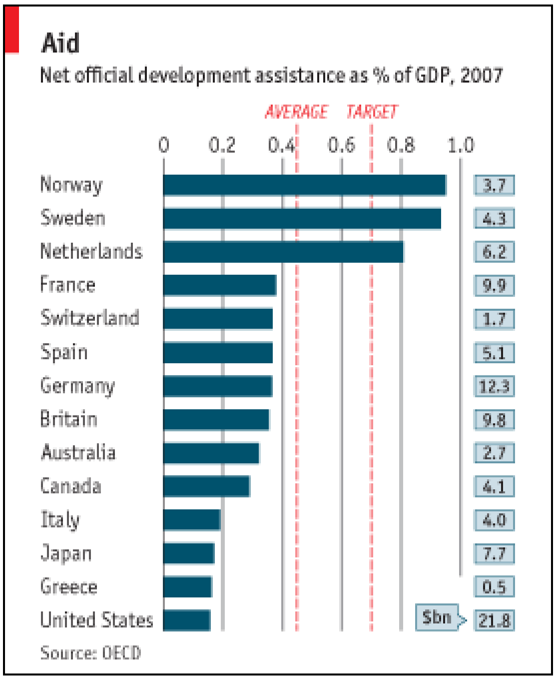
Markets

	Index Feb 18th	% change on one week	% change on Dec 31st 2007 in local currency	% change on Dec 31st 2007 in $ terms
United States (DJIA)	7,555.6	-4.8	-43.0	-43.0
United States (S&P 500)	788.4	-5.4	-46.3	-46.3
United States (NAScomp)	1,468.0	-4.1	-44.7	-44.7
Japan (Nikkei 225)	7,534.4	-5.2	-50.8	-41.3
Japan (Topix)	749.3	-3.7	-49.2	-39.4
China (SSEA)	2,320.1	-2.2	-58.0	-55.1
China (SSEB, $ terms)	137.9	-4.0	-64.7	-62.3
Britain (FTSE 100)	4,006.8	-5.4	-37.9	-55.8
Canada (S&P TSX)	8,176.0	-6.4	-40.9	-53.8
Euro area (FTSE Euro 100)	650.0	-6.6	-52.7	-59.5
Euro area (DJ STOXX 50)	2,118.5	-6.6	-51.8	-58.7
Austria (ATX)	1,481.4	-13.5	-67.2	-71.9
Belgium (Bel 20)	1,756.2	-6.8	-57.5	-63.5
France (CAC 40)	2,874.1	-5.1	-48.8	-56.1
Germany (DAX)*	4,205.0	-7.2	-47.9	-55.3
Greece (Athex Comp)	1,589.2	-8.9	-69.3	-73.7
Italy (S&P/MIB)	16,580.0	-8.3	-57.0	-63.1
Netherlands (AEX)	238.3	-5.9	-53.8	-60.4
Spain (Madrid SE)	831.1	-6.1	-49.4	-56.6
Czech Republic (PX)	628.5	-15.1	-65.4	-72.7
Denmark (OMXCB)	234.3	-1.8	-47.8	-55.2
Hungary (BUX)	10,353.4	-11.8	-60.5	-71.9
Norway (OSEAX)	266.4	-6.4	-53.3	-64.0
Poland (WIG)	21,320.8	-11.6	-61.7	-75.3
Russia (RTS, $ terms)	524.4	-15.5	-66.1	-77.1
Sweden (Aff.Gen)	195.8	-3.2	-42.5	-57.7
Switzerland (SMI)	4,955.5	-3.3	-41.6	-43.9
Turkey (ISE)	23,844.7	-6.1	-57.1	-70.3
Australia (All Ord.)	3,366.9	-1.5	-47.6	-61.7
Hong Kong (Hang Seng)	13,016.0	-3.9	-53.2	-52.9
India (BSE)	9,015.2	-6.3	-55.6	-64.9
Indonesia (JSX)	1,330.6	+0.4	-51.5	-61.8
Malaysia (KLSE)	895.2	-0.2	-38.0	-44.0
Pakistan (KSE)	5,880.1	+8.3	-58.2	-67.8
Singapore (STI)	1,651.1	-4.1	-52.4	-55.2
South Korea (KOSPI)	1,113.2	-6.5	-41.3	-62.6
Taiwan (TWI)	4,498.4	-1.7	-47.1	-50.5
Thailand (SET)	439.6	-1.0	-48.8	-51.2
Argentina (MERV)	1,054.9	-4.8	-51.0	-56.0
Brazil (BVSP)	39,674.0	-2.9	-37.9	-53.1
Chile (IGPA)	12,419.6	-0.5	-11.8	-26.5
Colombia (IGBC)	7,753.0	-3.4	-27.5	-42.9
Mexico (IPC)	18,741.3	-3.6	-36.5	-52.9
Venezuela (IBC)	37,879.2	+7.8	-0.1	-55.6
Egypt (Case 30)	3,529.8	-0.5	-66.3	-66.6
Israel (TA-100)	629.8	+0.4	-45.5	-49.4
Saudi Arabia (Tadawul)	4,773.8	-1.5	-56.8	-56.8
South Africa (JSE AS)	19,953.3	-5.2	-31.1	-54.1
Europe (FTSEurofirst 300)	763.4	-5.0	-49.3	-56.6
World, dev'd (MSCI)	791.4	-6.3	-50.2	-50.2
Emerging markets (MSCI)	516.3	-6.7	-58.5	-58.5
World, all (MSCI)	196.9	-6.4	-51.2	-51.2
World bonds (Citigroup)	763.5	-2.1	+4.5	+4.5
EMBI+ (JPMorgan)	384.3	-1.1	-11.4	-11.4
Hedge funds (HFRX)‡	1,036.6	+0.3	-22.0	-22.0
Volatility, US (VIX)	48.5	44.5	22.5	(levels)
CDSs, Eur (iTRAXX)†	171.1	+15.8	+238.0	+189.7
CDSs, N Am (CDX)†	235.1	+9.2	+201.8	+201.8
Carbon trading (EU ETS) €	9.7	+14.3	-57.5	-63.6

*Total return index. †Credit-default swap spreads, basis points.
Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Reuters; WM/Reuters; JPMorgan Chase; Bank Leumi le-Israel; CBOE; CMIE; Danske Bank; EEX; HKMA; Markit; Standard Bank Group; UBS; Westpac. ‡Feb 17th

Aid

Feb 19th 2009
From The Economist print edition



Net flows of foreign aid from the rich countries in the OECD's Development Assistance Committee amounted to $103.5 billion in 2007, the latest year for which data are available. However, countries spent very different fractions of their GDP on aid, according to the think-tank. The Netherlands, Norway and Sweden, with Denmark and Luxembourg (not shown in our chart), were the most generous by this measure. By giving more than 0.7% of their GDP in aid, they exceeded a UN target. In contrast, America's aid was worth only 0.16% of its GDP. But America's economy is enormous, so its $21.8 billion aid budget was still the biggest in absolute terms. In second place was Germany, which spent $12.3 billion on aid in 2007.